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THE BANK LIQUIDITY CRISIS AND ASSET-BASED LENDING

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The author examines the current liquidity crisis facing banks and other financial institutions, focusing on the manner by which many of the banks participating in the equipment (and other) finance markets fund themselves to make (and carry) loans.

The current liquidity crisis facing banks and other financial institutions is of historic proportions. The crisis in the aircraft, rail and other equipment bank finance markets (as well as, of course, most other finance markets)[1] manifests itself primarily in one of two ways:

- True Liquidity Crunch — Lenders are not willing to lend to borrowers at all.
- Pricing Crunch — Lenders are not willing to lend to borrowers unless they receive much higher spreads over LIBOR.

As a lawyer whose practice is representing parties financing transportation assets, including numerous banks, the dramatic evaporation of new business in the face of this liquidity crisis has been quite startling. With clients and colleagues bemoaning the grim situation, it seemed opportune to write this piece to explain what was happening.

To understand the nature of this crisis, this article provides a brief overview

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of the manner by which many of the banks participating in the equipment (and other) finance markets fund themselves to make (and carry) loans.

In contrast to financial institutions such as insurance companies which have access to large sums of cash generated by insurance premiums, the banks in this market obtain funds to make, and maintain, loans to their borrower customers primarily by themselves borrowing funds from other banks; they borrow from Peter to lend to Paul.[2] They make their money, then, by charging their borrowers a margin over the banks' own borrowing costs, which margin reflects their borrowers' credit risk and the banks' return requirements. Since borrowers want an objective publicly available benchmark rate for determining the interest they are required to pay, and banks do not always care to reveal their own cost of funds, a proxy market standard for assessing the banks' cost of funds for U.S. Dollar-based borrowings is the published rate called the "LIBOR" rate, which is the London interbank offered rate. LIBOR rates are short-term fixed rates that are quoted for "interest periods" of, typically, one, two, three and six months. So, these LIBOR rates are good for the duration of agreed interest periods, and are reset at the end of the interest period to reflect market conditions. The actual LIBOR rate utilized in the market is posted on an electronic screen by Reuters, and reflects the British Bankers Association's (BBA) determination of an average rate quoted by 16 money center banks as their individual cost of funds to borrow in the London interbank market, thereby reflecting an industry benchmark rate.[3] Accordingly, for loans borrowed in this market, borrowers are assessed interest at the LIBOR screen rate for each relevant interest period plus the applicable credit margin.

The usefulness of the LIBOR rate as an appropriate benchmark for your typical bank's cost of funds for any interest period presupposes the following:

1. Such bank's cost of funds for any particular interest period closely approximates the screen-based LIBOR rate; and
2. Such bank can obtain funds in the interbank market for such interest period in any event.

Insofar as the screen-based LIBOR rate is an average of quoted rates, any particular bank's cost of funds for any interest period may naturally be high-

er or lower than the screen rate. Whether higher or lower will depend, largely, on such bank's credit quality; the better its perceived credit, the lower the interest rate other banks will charge it. The banks that are not of the highest credit quality will typically adjust (higher) the margin they charge their borrowers to take account of their own higher borrowing costs relative to the LIBOR screen rate. Historically, higher interbank borrowing costs have hit whole classes of banks — in the early 1990s, Japanese banks were almost universally assessed an interbank market premium of 20-100 basis points over screen-rate LIBOR rates due to credit concerns endemic to the Japanese economy.

The current liquidity crisis has radically challenged the presuppositions on which LIBOR-based lending is based. Not only are banks' borrowing costs far higher than the quoted screen rates, but most banks are literally unable to borrow altogether for any of the monthly-standard interest periods. During the most difficult periods of illiquidity in September and November of 2008, many banks were unable to access funds in the London interbank market other than on an overnight or other short-term (e.g., weekly) basis; i.e., rather than borrowing for prescribed interest periods in the interbank market, banks are extending credit to each other in the interbank market on a day-to-day (or weekly) basis only. Apparently, banks are extremely wary of other banks' credit risks and not willing to grant other than very short-term loans.[4] Some banks are even finding that overnight funds are not available altogether or, even if available, they are unwilling to place themselves at risk of a failed overnight rollover or constantly shifting interest rates which may move adversely relative to a screen rate for a contractually prescribed interest period.

As noted above, banks are reporting that the BBA's posted LIBOR screen-rate does not reflect their cost of funds by factors well in excess of any deviations (based on their relative credit) to which they were subject before the current liquidity crisis. This raises two interesting questions: first, why aren't the BBA banks quoting true cost of funds rates and second, on what basis are the BBA banks quoting rates for multi-month LIBOR rates when no one is lending for such long (!?) maturities. As to the first question, we can speculate that the BBA banks are reluctant to report to the market on a "name" basis their true cost of funds, as they do not want to look bad in front of their peers as having pricey borrowing rates reflective of their (dicey) cred-

it. As to the second question, we can speculate that these banks are literally making up rates for these interest periods based on some guess work on what they think the market would charge them (but see first issue!).

This state of affairs has the following consequences to banks:

1. As to the trillions of dollars of loans that have been funded to borrowers on a LIBOR basis, banks are suffering serious erosions of their profit margins[5] on their loans since their cost of funds are not matching the quoted LIBOR screen rates;[6]
2. Banks are not willing to make new loans because: (i) they are hoarding whatever capital is at their disposal to shore up their balance sheets so as to be able to meet capital targets and calls on capital;[7] (ii) they are having difficulty obtaining funds in the interbank market; (iii) in many cases, even those funds that are available are available day-to-day since access is typically on an overnight basis, so there is no assurance of continued availability or pricing stability; and (iv) the industry standard LIBOR benchmark is not reflective of funding costs;
3. For the fortunate few borrowers who are able to access bank financing, these borrowers are required to pay much higher margins relative to LIBOR or, more commonly, a bank stipulated cost-of-funds rate plus an applicable credit margin;
4. Banks are seeking documentary outs so as to avoid having to lend on unfunded commitments. While most bank commitments are ironclad without any outs, a number of facilities have what is called a LIBOR disruption clause, which provides that it is a condition precedent to any particular funding that there not be a continuing "material disruption in the London interbank markets." While we lawyers were never quite sure what that might be when we were adding such a condition precedent into our documents, it is somewhat universally accepted that we are in the middle of such a disruption for all of the reasons outlined above;[8] [9] and
5. Borrowers are drawing down on available bank lines/facilities because of their concerns that their banks will be unable to fund their commitments.[10]

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As banks seek to address their funding issues relative to this liquidity crisis, we are seeing two distinct approaches for those banks still open for business.[11] The first, and more common, approach is that banks are seeking to have a LIBOR market disruption clause inserted in loan documentation that enables them to charge their own cost of funds in lieu of the LIBOR screen rate if the LIBOR screen rate does not adequately and fairly reflect their cost of funds. The second approach, adopted by a number of German banks, is that these banks are requiring the addition of a liquidity margin that supplements the credit margin over the life of the entire transaction.

The first such approach (the "Cost of Funds Approach") is one that has been seen in various guises in the bank financing market. In transactions documented in Europe (primarily English law governed documentation), there exists an industry standard as adopted by the London-based Loan Market Association (LMA) that provides, in part, that a bank may charge its cost of funds if "the cost to it of obtaining matching deposits in the Relevant Interbank Market would be in excess of LIBOR." In a number of U.S.-based transactions, primarily widely syndicated unsecured loan facilities, the failure of the LIBOR screen rate to adequately cover cost of funds would kick-over the interest rate basis to "base rate" loans, which typically is the higher of the announced "prime rate" by a New York money center bank or Federal Funds plus 1/2 of one percent. The LMA approach is deficient insofar as it presumes availability of matching deposits in the London interbank market; as noted above, many banks are unable to access deposits in the interbank market on other than a short-term basis. The U.S.-based approach is deficient for most European-based lenders as neither U.S. "prime rate" nor Federal Funds rates have any operational meanings for them insofar as they have no ability to access funds at those rates.[12]

The second approach (the "Liquidity Margin Approach") reflects the statutory requirement for a number of German banks to lock-in funding availability at the time it commits to provide funding for a transaction *for the entire tenor of the transaction*. In other words, these banks must find counterparties that are willing to lend to them LIBOR (at whatever the underlying transaction's interest period periodicity) for the period commencing on the anticipated closing date through the anticipated maturity date. The liquidity margin that the bank charges its borrower is the margin over LIBOR

such bank's counterparty would charge to it for the commitment to continuously roll over the interbank deposit over the life of the deal.[13]

From a borrower's perspective, there are pros and cons to each of these two approaches. The Cost of Funds Approach has the benefit of being (one would hope) short term (so it would go away once/if the LIBOR markets settle down) while the liquidity margin charged under the Liquidity Margin Approach will be assessed throughout the entire life of a transaction. In addition, the Cost of Funds Approach should be, on a "spot" cost basis, cheaper than the Liquidity Margin Approach (which has an embedded cost relating to the long-term commitment).[14] The Liquidity Margin Approach has the benefit of being a known and assessable cost that can be factored into long-term planning, whereas the Cost of Funds Approach creates a universe of future unknowns since a bank's costs can change over time. What is more, the Cost of Funds approach makes the borrower susceptible to a particular bank's credit, which is a risk factor outside of the borrower's control.

Once a particular approach is adopted as a condition for the extension of credit, a mutually satisfactory way of determining a "cost of funds" or "liquidity margin" must be agreed. That being said, banks are absolutely insistent on not providing any borrower (or anyone else, for that matter) with any ability to second guess its cost of funds or liquidity costs. That information comes from the bank's "Treasury Desk," and its determination is necessarily conclusive; as one can imagine, a bank's assessment of its cost of funds (or liquidity cost) is a complex evaluation of its funding sources.[15] For this reason, banks are insisting on documentary formulations such as: "The report by any Lender to the Agent of its cost of funds for any Interest Period shall be conclusive and shall constitute a certification by such Lender that the interest rate so provided is an accurate and fair calculation of its Treasury-assessed funding costs for such period, and that such assessment has been made on a fair and non-discriminatory basis."

As borrowers consider (and are forced to accept) this type of formulation, they may wish to consider the following issues:

1. A cost of funds comparison to the LIBOR screen rate may not always be a valid standard, depending on the bank. If a bank historically (i.e., prior to the current liquidity crisis) paid in excess of LIBOR (flat) on an inter-

bank basis, then that bank should be entitled to go to a cost of funds basis only when the LIBOR screen rate *plus* its normal over-LIBOR spread, exceeds its cost of funds.

2. Banks typically seek the unfettered ability to transfer their loans and commitments. It might be appropriate to prohibit transfers where the intended transferee would be changing a higher cost of funds than the transferor.
3. To be sure, one tremendous aversion to a cost of funds provision is that the borrower is subject to a non-objective standard ("it is what I say it is"). There may be banks that are willing to consider an alternative objective screen rate that they could agree to up-front as a proxy for their cost of funds.
4. Many transactions have prepayment blocks and prepayment fees. Perhaps it would be appropriate to allow a prepayment/refinancing of the transaction without such a block or a fee if the borrower is being assessed a cost of funds interest rate.
5. A borrower may want to add a "yank-a-bank" provision that would entitle the borrower to prepay or refinance a bank that is charging cost of funds.

CONCLUSION

The governments of the major economic powers are struggling to find the right combinations of policy initiatives to ease the liquidity crisis and restore confidence in the interbank markets. Whatever the eventual outcome, one can be sure that accepted forms of LIBOR-based loan documentation will be revisited (i) to ensure banks are able to protect their cost of funds and credit margins from disruptions in the interbank markets and (ii) to provide borrowers with some modicum of comfort that the interest rates they are to be charged based on non-screen rates are fair.

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NOTES

[1] This article does not address the problems in the capital markets which had preceded the banking liquidity crisis by some 12-18 months.

[2] This may be something of an overstatement, since many (of the lucky!) banks have a deposit base on the basis of which they have a pool of funds to make loans, and banks also raise funds by issuing commercial paper, bonds, preferred stock and common equity. Having said that, the model that serves as the basis for standard fund sourcing and loan pricing is the back-to-back borrowing model.

[3] Actually, of the 16 rates received, the BBA throws out the four highest and the four lowest, and averages the remaining eight quotes.

[4] This is the much touted crisis of confidence in the interbank market. What exacerbates this problem is the tremendous lack of faith in bank financial statements, where so-called "toxic" assets may not be properly valued (i.e., discounted) and "toxic" liabilities such as exposure to credit default swaps and other exotic derivatives may not be properly disclosed.

[5] For loans with relatively low credit margins, the cost of funds/LIBOR screen rate differential is in some instances large enough to cause actual losses for the banks since the cost to the bank of continuing to fund these loans is greater than the LIBOR screen rate plus the credit margin that the borrowers are paying.

[6] There are a number of existing credit facilities (predominantly syndicated and unsecured revolving credit and term loan facilities) that allow the banks to force the borrower to move to a different interest rate standard (typically, the higher of (x) US prime/base rate and (y) the federal funds rate plus 0.5 percent, flat [no margin]) if the banks in the facility advise the agent bank that the LIBOR rate does not adequately and fairly reflect their cost of funds. Since the alternate interest rate may itself remain insufficient relative to the bank's cost of funds, this has not proved to be much of a panacea. Interestingly, many English law-governed documents, on the other hand, provide that the alternate interest rate in such instance is the bank's cost of funds (non-U.S. banks do not have "prime rate" or "Fed funds" benchmarks) plus the credit margin. See *infra.* text at fn. 12.

[7] Such as a run on deposits.

[8] Much like pornography, you know it when you see it (apologies to Justice Stewart).

[9] Having invoked this "out" when a borrower seeks to borrow under a committed facility, we are finding that most banks are willing to fund if they can re-address the credit margin and add in a cost-of-funds interest rate basis.

[10] These drawings have exacerbated the liquidity crunch. The utilization of bank liquidity for these purposes, of course, makes liquidity less available for new facili-

ties. The borrower concern of *bank* credit is not unwarranted; a number of Icelandic banks which were participants in committed bank facilities were unable to meet borrowing requests.

[11] It is important to note that the cost of funds issue is an issue for banks even if a particular transaction is quoted on a fixed rate basis. This is because in a fixed rate deal the bank is swapping the fixed rate interest-related cash flow it is receiving from its borrower for LIBOR under an interest rate swap. Therefore, the banks offering fixed rate interest are seeking cost of funds protection which would entitle them to the differential of cost of funds over the LIBOR applicable to each interest period.

[12] These borrowing bases may, in fact, be *lower* than the LIBOR rate.

[13] Those banks opting for the Liquidity Margin Approach would not be entitled to a cost of funds fallback option since they have presumably locked in their cost of funds for the life of the transaction.

[14] By way of example, we are seeing cost of funds premiums over LIBOR of 60 basis points and liquidity margin of 200 basis points.

[15] Which may be as diverse as retail deposits, interbank borrowings, common and preferred stock equity, commercial paper and bond issuances.