



Financial Markets Crisis Task Force

Bringing Legal Clarity to the Economic Crisis

Corporate Finance

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Lenders Seek to Eliminate Prime Rate Option

The dramatic reduction in the prime rate of interest taking over the last six months has caused lenders to seek to eliminate that interest rate option.

Commercial lenders generally price loans by reference to the prime rate or the libor rate. Libor stands for “London Inter-Bank Offered Rate,” and it is based on rates that contributor banks in London offer each other for inter-bank deposits. The prime rate, as reported by the Wall Street Journal’s bank survey, is based on the fed funds rate (historically 300 basis points above the fed funds rate), which is set by the Federal Reserve.

Commercial loans often feature both a prime rate option and a libor rate option with the borrower free to choose between the two interest rate options throughout the course of the loan. As the prime rate has historically been roughly 250 to 300 basis points higher than the libor rate, the borrower’s libor rate option generally includes a margin sufficient to keep the libor rate roughly 50 to 100 basis points less than the prime rate after applying the margin.

The steep decline in the prime rate over the last six months has disrupted the historical relationship between the libor rate and the prime rate. The prime rate now stands at 3.25%, its lowest level in over 50 years. And although the one-month libor rate has also declined to only .25% (after spiking during the seizing of the credit markets during the Fall), it simply did not have as far to fall, thus causing the prime rate option to become more favorable to borrowers than libor.

As a result, banks have taken a variety of several steps to mitigate the effects of this interest rate anomaly, including:

- ▶ Eliminating the prime rate option altogether
- ▶ Changing the definition of the prime rate to the one month libor rate, plus the applicable margin
- ▶ Eliminating the prime rate option if it becomes less than the libor rate
- ▶ Placing a floor on either the prime rate or the libor rate or both
- ▶ Increasing the applicable margin to prime rate loans, essentially forcing borrowers to accept the libor rate option

Borrowers seeking to extend or modify the terms of existing commercial loans should therefore not be surprised if their lenders take any of the above actions to mitigate their interest rate exposure for loans having a prime rate option. Borrowers violating financial covenants may also face similar lender requests to alter interest rate provisions in exchange for granting waivers. Indeed, some lenders have even attempted to address this situation in the absence of any default or borrower-requested change to existing loan documents.

In sum, most lenders will seek to address this interest rate anomaly given the opportunity to do so. Borrowers would thus be best served by laying low and staying off their lenders’ radar screens. Indeed, in this interest rate environment, no news from your banker seems to be good news.

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