The LIBOR Floor Is Rising

For many investment-grade borrowers, a LIBOR floor could double the funding spread on a loan.

As interest rates collapsed during the financial crisis of 2008, lenders began incorporating LIBOR (London Inter-bank Offered Rate) floors into credit facilities primarily for non-investment-grade companies. These provisions have also been far more common in European loans as rates there have been negative for several years. (We recently discussed the topic.) The vast majority of U.S. investment-grade facilities, however, have avoided these LIBOR floors.

Now, as 1-month USD LIBOR rates have plummeted over 150bps to 0.17% during the economic shutdown, lenders have been successful in adding these floors to new or amended investment-grade credit facilities.

Borrowers can appreciate the significant economic value of this concession by quantifying the floor in the derivative markets and incorporating that information into their credit facility negotiations. Roughly speaking, a 1% LIBOR floor on a 5-year facility has a present value of over 4%!

For a $1 billion loan, that upfront value is over $40 million — an amount many multiples greater than the upfront lender-fees paid on a typical investment-grade facility. Expressed differently, adding the LIBOR floor is equivalent to increasing the borrowing spread by over 80 bps per annum.

For many investment-grade borrowers, this could double the funding spread on the loan. To be fair, the floor may be less relevant for facilities that are expected to remain undrawn or retired prior to maturity. However, the economic cost, and likely the direct cost, of the floor is very real for borrowers who fund on these facilities.

Tenor and strike are two primary structural factors that drive the value of a LIBOR floor.

The tenor describes the term of the floor. A 5-year is more valuable for the lender and more costly to the borrower than a 1-year floor because the lender retains the protection from lower rates for a longer period of time. The strike is the stated rate under which the borrower does not benefit from declines in LIBOR.

For instance, a 1% floor allows the lender to replace any future LIBOR settings below the floor with the floor itself. The higher the floor, the more valuable the option is for lenders and the more costly it is for borrowers.

The present value calculation of the floor price is based on several market inputs including the LIBOR index, the term structure of interest rates, volatility, and liquidity. To get a better sense of this value, we provide a table below depicting mid-market upfront prices of 1-month LIBOR floors for various tenors and strikes utilizing prevailing market conditions on May 19, 2020.

Tenor	0.0% Strike	0.5% Strike	0.75% Strike	1.0% Strike
1 Year	3 bps	32 bps	54 bps	78 bps
2 Year	11 bps	71 bps	117 bps	164 bps
3 Year	28 bps	114 bps	179 bps	248 bps
4 Year	50 bps	158 bps	240 bps	328 bps
5 Year	75 bps	203 bps	298 bps	403 bps

Interestingly, zero-strike floors have a value even though LIBOR is currently positive. For 1 year, a zero percent floor is worth 3 bps upfront, and, for a 5-year, a zero percent floor is worth 75 bps upfront or over 15 bps per annum. The derivative incorporates the probability-adjusted future value of LIBOR and is not dependent on the actual future path of LIBOR.

Some borrowers might justify adding a zero percent floor on a 1-year facility because of the minimal economic cost of the floor. The issue with that approach is that adding any floor mechanism sets a precedent that makes it easier to raise the floor strike and makes it harder to remove that floor, in the future. Borrowers must also be attentive to the potential accounting implications on the hedges on facilities where the underlying terms are amended or modified.

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David Greenberg and William Kloehn. "The LIBOR Floor Is Rising." CFO Magazine, May 20, 2020,
https://www.cfo.com/credit/2020/05/the-libor-floor-is-rising/