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Interest Cover Ratio default?

Higher global interest rates are continuing to add pressure on borrowers' ability to comply with interest cover financial covenants and service the interest on their outstanding debt. In this finance briefing we consider the key initial steps and issues for lenders and borrowers facing a potential default of interest cover financial covenant in a real estate finance investment loan agreement.

	Legal considerations	Practical considerations
 1. What is ICR?	In determining whether a borrower can pay the interest on its outstanding debt, lenders will look at the interest cover ratio (“**ICR”**) financial covenant. Usually calculated as “*passing rental as a percentage of finance costs*” as at certain test dates, the ICR is the proportion (expressed as a percentage) that the net rental income received or receivable during the relevant period bears to the finance costs for that same period. ICR will be required to be maintained at specified levels throughout the term of an investment facility. Since the global financial crisis and the general reduction in the degree of leverage in the real estate lending market, the levels of ICR agreed on loans have generally provided for substantial headroom before the borrower will be unable to service ongoing interest payments. The ICR can be tested on a historical and/or projected basis. Each relevant period is usually 3, 6 or 12 months and either starts or ends on the date the ratio is tested. If the relevant facility allows multiple drawdowns, compliance with both the Projected Interest Cover and Historical Interest Cover ratios (see below) are usually conditions precedent to each drawdown.	ICR calculations are to be made by the borrower and submitted to the lenders quarterly in a Compliance Certificate or at the request of the lenders. If the borrower does not provide the calculations as required or the lenders disagree with the calculations provided, usually the lenders may calculate the relevant interest cover ratio and that calculation shall prevail over any calculation of the borrower.

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 2. Historical Interest Cover	The financial covenant will usually provide that "*the Borrower must ensure that Historical Interest Cover is, at all times, at least X%*". This is a "backward-looking" test where the relevant period **ends** on the date the ratio is tested. There is usually provision setting out how passing rental is calculated, including any amounts to be deducted to reduce the rental income to a net figure, e.g. ground rent payable for leasehold properties. The facility agreement will usually include various assumptions about issues such as break clauses (i.e. that a break clause will be deemed to have been exercised at the earliest date available) and rent reviews (i.e. that net rental income increases as a result of rent reviews will be ignored until unconditionally ascertained). When calculating the finance costs for a Historical Interest Cover test, the lender will include all interest and often all regular fees, e.g. commitment fees, agent and security trustee fees, payable to it and any hedging costs payable at that time.	If the loan is provided on a floating basis and references a compounded in arrear risk-free rate ("**RFR**"), such as SONIA or SOFR and there is not an interest rate swap in place in respect of the nominal amount of the loan, due to the way in which SONIA is calculated the borrower and the lender may not know the extent of the interest that will be payable until very close to the time that the covenant is to be calculated. To avoid unpleasant surprises, the borrower and lender may wish to calculate the figures in advance based on current expectations of interest rates and the level of anticipated rent.
 3. Projected Interest Cover	A Projected Interest Cover covenant will provide that "*the Borrower must ensure that Projected Interest Cover is, at all times, at least X%*". This is a "forward looking" test where the relevant period **starts** on the date the ratio is tested. It is important to check the definition of "passing rental" along with the sub-paragraph detailing how this is calculated for a Projected Interest Cover ratio as these are usually negotiated and considered on each transaction. The amount of rental income that will be received by the borrower in relation to the future period is estimated on figures available to the borrower and the lender at that time. A lender will want to ignore any rental income due from a tenant that is insolvent. The effect of break clauses rent reviews and arrears may also have been negotiated at the time of entering into the loan agreement. Finance costs are calculated on the same basis as for Historical Interest Cover but by reference to a *future* period (instead of amounts due at the time). Where the facility	The borrower will have been preparing calculations throughout the life of the loan but should be aware of any adjustments that may need to be made where there are arrears or tenant insolvency or other matters specified in the loan agreement.

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	references a compounded in arrear risk-free rate (“**RFR”**), such as SONIA or SOFR and there is not an interest rate swap in place in respect of the nominal amount of the loan, as the interested is calculated just before the payment date, a solution for calculating this in advance of the interest period has to be agreed, e.g. using an estimate of the average of the overnight RFR during the look-forward period; an average of past RFR rates (e.g. the average over the past 365 days), or the most recent RFR rate published on the test date for the duration of the look-forward period.	
 4. Can the ICR be remedied?	The loan agreement may contain a “**Cure Right**” pursuant to which the borrower may typically either: (a) deposit an amount into a Cure Account; and/ or (b) prepay the loan, in each case in an amount required to ensure compliance with the relevant ICR covenant. Some Cure Rights may be drafted instead so that rather than prepaying the loan, the cure amount is treated as being additional net rental income during the relevant period (which would mean the borrower depositing much less cash in comparison). There will be usually be a restriction on the maximum number of times that the Cure Right may be exercised annually and/or during the term of the loan and a requirement that they not be exercised in consecutive interest periods or more than a limited number of consecutive periods.	It is important to check the terms of any Cure Right carefully to see how it operates in terms of timing and amounts. Even where a Cure Right is available, the lenders will be monitoring and considering the potential default in respect of Projected Interest Cover and any potential further defaults in respect of Historical Interest Cover. Depending on the relationship with the borrower and subject to their credit approvals, the lenders may consider potential waivers/amendments (conditional or otherwise) or a temporary relaxation of the relevant ICR covenant alongside a partial repayment or cash cover deposit, outside of the Cure Right mechanism. See also our comments that apply in section 5 below (**Where no Cure Right is Available**).
 5. Where no Cure Right available	Where there are no Cure Rights available for the borrower to remedy the relevant ICR covenant breach, an Event of Default (“**EOD**”) will have occurred and be continuing when the covenant is breached. Lenders will be cautious to preserve their rights in relation to this and will usually seek to issue a reservation of rights letter promptly, to reduce any risk that the lender may be deemed to have waived the EOD (and should also ensure their conduct is not inconsistent with their reservation of rights to avoid the suggestion they have waived the EOD). Depending on the scale of the potential ICR breach, the borrower’s financial condition and the figures provided in respect of the rental income actually received (along with	Lenders will undertake an information gathering exercise to understand the scale of the potential/actual ICR breach, the borrower’s financial condition and the prospects of rental income being improved at the relevant property: • Is this an isolated breach which can be remedied relatively easily (e.g. because sponsor equity injection forthcoming)? • Is it thought to be a temporary blip in the commercial real estate market affecting all properties or is it specific to this property/this borrower?

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	the prospect of future rental income to be received) and subject to obtaining credit approvals, the lenders may be willing to issue a waiver letter (which may have conditions attached e.g. a cash trap, a limited period for the waiver or a period of time for cure or injection of equity for breach of financial covenants or to allow for a refinancing or a voluntary sale or additional leases to be put in place), which should comply with requirements in the underlying finance documents (including any lenders' consent thresholds).	• Has the income stream from the property declined? • Are there broader issues, for example, issues with the borrower's management team, issues with tenants or a particular tenant not paying rent when due or with management of secured properties by current managing agent or asset manager? Lenders may consider it appropriate to require cash sweep or cash lock up arrangements and to limit any distributions as part of the arrangements where they stray from the strict requirements of a built in Cure Right. Borrowers and lenders will need to understand the cause of the issue and how that will be mitigated at the end of any period of waiver of relaxation.
 6. Security review	Depending on the nature and extent of the ICR breach, where the lenders' credit teams have asked for an understanding of their situation on a potential enforcement or restructuring, the lenders may instruct lawyers to review their existing security package to ensure the lenders have valid and enforceable security (e.g. registration and perfection requirements met) and to consider the enforcement routes which may be available.	As the borrower is typically expected to cover the cost of any security review, there may be discussions over the scope of any such review required at this stage.

For our discussion of the initial steps and issues for lenders and borrowers facing a potential default of loan to value financial covenant in an investment loan agreement, see loan-to-value-default (cms-lawnow.com). We will look at the next steps for lenders considering enforcement and restructuring options in separate briefings.