Loan
Market
Association

10 Upper Bank Street
London E14 5JJ
Tel. +44 (0)20 7006 6007
Fax +44 (0)20 7006 3423
lma@lma.eu.com
www.lma.eu.com

Keith Billing Esq
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS
Sent via email: k.billing@frc.org.uk

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Dear Sirs

FRC consultation on implementation of the EU Audit Directive[1] (the "Directive") & Audit Regulation[2] (the "Regulation") (the "Consultation")

The significance of high quality corporate governance and reporting standards is well understood by the members of the Loan Market Association (the "**LMA**"). Furthermore, the LMA supports the FRC's underlying aims for audit - in particular, the need for clearly defined and well-understood roles and responsibilities for auditors (aligned with the interests of investors), the importance of audit quality, the need for sufficient competition and choice of audit firm and the importance of appropriate oversight of the industry as a whole.

With this in mind, the LMA would like to highlight a particular point in the Consultation that we believe would benefit from further clarification, in order to ensure that the requirements operate effectively, are appropriately targeted, and do not create disproportionately burdensome requirements which are of little or no practical use to the entities they were designed to assist.

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 576 across 56 nationalities and consists of banks, non-bank investors, law firms, rating agencies and service

[1] Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts
[2] Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the European loan market vis à vis lenders, borrowers, regulators and other interested parties.

Given that many of the LMA's members are banks, they will fall within the definition of "Public Interest Entities" ("PIEs") under the Directive[3]. Consequently, the provisions of the Regulation (which contain special provisions for the statutory audits of PIEs) and the manner in which the Regulation is implemented in both the UK and other Members States, will be directly relevant to them.

Rather than providing a response to all of the detailed questions in the FRC's Consultation, there is one issue which is of particular relevance in the context of the syndicated loan market. We draw this issue to the attention of the FRC in the context of Question 27: *"are there any other possible significant impacts that the FRC should take in to consideration?"*

Summary

Under Article 5 of the Regulation, "a statutory auditor or an audit firm **carrying out the statutory audit of a public-interest entity**, or any member of the network to which the statutory auditor or the audit firm belongs, **shall not directly or indirectly provide to the audited entity**, to its parent undertaking or to its controlled undertakings within the Union **any prohibited non-audit services**" during a specified period.

In our view, the impact and scope of this prohibition is subject to broad interpretation which could cause a large amount of confusion in the market – for example, whilst the principal intention is clearly to prevent a PIE from obtaining a non-audit service from its own auditor in relation to its own business, the wording could also arguably capture a bank PIE that commissions a non-audit service in respect of a customer's business (e.g. it commissions a valuation report in relation to a corporate to which that PIE has extended a loan). Our initial view is that the wording should be interpreted in the spirit in which it was clearly intended – i.e. that only non-audit services relating to a PIE's own business should be caught by the legislation. This is the first point on which we would ask that the FRC provides clarification.

In the event that the FRC does not agree with this analysis, we would suggest that a derogation afforded in the Directive to member states exempting such activity be used, if the criteria set out further in our response are satisfied.

In the event that the FRC does consider that non-audited services relating to a PIE's customers should be caught, whilst the impact and scope of this prohibition is clear where there is a simple bilateral relationship between a customer, a lender that is a PIE and their respective auditors, the situation becomes altogether more complex where a borrower has entered into a syndicated loan with a group of lenders (many of whom will be banks and

[3] Article 1, Paragraph 2, Sub-Paragraph (f).

therefore PIEs) and it is the syndicate of lenders who are commissioning the non-audit services from the auditor, rather than the borrower itself.

We do not believe that these types of scenario have been considered in the Consultation, and therefore clarity is needed as to how any rules will apply as, for example, it would not be practical to consult with the audit committee of every lender within the syndicate to confirm that any proposed actions are acceptable to them. Furthermore, even if this was done, the situation could create significant confusion if those audit committees had conflicting views. Rather, it needs to be clear, both to the agent bank or to whatever lending group will take decisions on behalf of the syndicate (in most syndicated loan arrangements, a group of lenders with a majority share of the loan) and to audit committees, that what is being proposed will not create an issue for any of the banks within a lending syndicate.

We set out the extent of the issue in more detail below.

Brief introduction to syndicated lending

A syndicated loan facility may be a term loan, a revolving loan, a standby letter of credit facility, a guarantee facility or some other similar arrangement. In each case, it involves **two or more institutions** contracting to provide credit to a particular corporate or group. Under a syndicated loan, the borrower will typically appoint one or more lenders as "arranger(s)" which will then proceed to sell down parts of the loan to the other lenders, whilst retaining a proportion of the loan itself/themselves. The arrangement is put together under one set of terms and conditions, but each institution's liability is limited to the amount of its participation. As a result, the syndicated loan market facilitates the sharing of credit risk, and it is therefore possible for a large number of investors to participate in facilities of various amounts, well in excess of the credit appetite of a single lender. Although syndicate lenders increasingly include various types of non-bank lenders including funds, insurance companies and CLOs, the largest component of the lending group is usually banks.

Practical examples

In many types of lending arrangements, whether at the outset of the transaction as a condition precedent to receiving the loan or during the life of the loan itself, advisors such as accounting firms, strategy consultants, technical consultants, valuers and lawyers will be engaged by the borrower, with reports being commissioned as a result. The members of the banking syndicate rely on such reports either as part of the initial due diligence process or to enable them to monitor the borrower's business and they therefore require a duty of care to be given by any report provider that the borrower instructs.

We would assume that this type of activity is not intended to be within the scope of the prohibition on the basis that, although the banks may seek to rely on any reports produced, the banks do not commission the work themselves (and are not addressed in the relevant engagement letter) and therefore any non-audit services provided in this context are not "provided" (either directly or indirectly) to the banks. However, to avoid any confusion and

potential delays caused by different legal interpretations of the legislation, we would suggest that the FRC clarifies this.

In addition to the situation described above, there are times, especially when the borrower is, or appears to be, in financial difficulty when the banking syndicate may wish to commission work on its own behalf. This may include work undertaken by a variety of advisers, but would invariably include work undertaken by an accounting firm to help the banks understand the financial position of the borrower, the aspect of its financial performance that is causing the apparent difficulty, the achievability of projections received from the borrower, and advice regarding the options available to the syndicate.

In this situation, each bank would not commission its own report - rather, the agent bank, the steering group or whatever other group of lenders had been established under the loan agreement to act on behalf of the syndicate would arrange, based on whatever consultation procedures were prescribed in the loan agreement, for the work to be performed by one adviser in each relevant area and to provide whatever services and advice were considered appropriate. Given that these reports would usually be addressed to each of the finance parties under the loan agreement (or to the agent on their behalf) it is at least arguable that each bank within the syndicate might be viewed as commissioning the work (especially because they would often all be referred to in the relevant engagement letter).

Thus, given that the legislation prevents a PIE from engaging its own auditor for non-audit services, this could conceivably create a situation (at least in the absence of clarification) where there was no choice of audit firm available from the larger accounting firms simply on the basis that those firms would likely be auditor of at least one bank within the syndicate.

This lack of choice would often be limited even further by the fact that the borrower will have its own auditors and may have appointed a separate accounting firm as its own advisors, and so these two firms would also be "off the list" of accounting firms appropriate for the banks to engage.

In view of this potential significant restriction of choice and the confusion that would likely exist as to how the rules should be applied for a banking syndicate, we believe that the implementation of the Regulation through the FRC Ethical Standards should provide as much clarity as possible on this issue.

Potential solution

In our view, the simplest solution would be to confirm that the legislation is only intended to extend to non-audit services in respect of a PIE's own business, and not that of its customers.

In the event that this interpretation is rejected, a potential solution for syndicated loans exists if the restrictions placed on a banking syndicate's choice of audit firm were limited to any bank that was, on its own in a position to control the syndicate (a situation which, with

regards to syndicated loans would very rarely exist since most decisions are made with either majority lender or all lender consent). This solution would preserve the ability of bank syndicates to obtain services from a range of accounting firms, while at the same time not conflicting with the objectives of the Directive and Regulation regarding the independence of auditors and the quality of their audits. This is particularly the case when you consider that:

- The accounting firm is being engaged for the benefit of the syndicate as a whole, and hence the presence of the other syndicate members provides a safeguard to any issues that could come from the relationship between the accounting firm and those members of the syndicate that it does audit;
- advice is provided to the syndicate as a whole, with each member then making its own decisions based on the common advice provided;
- the fees are generally paid by the borrower rather than by the banks; and
- the situation we are raising originates within the operational/transactional part of the banks and is generally a long way from those who prepare the banks' financial statements and the audit of those financial statements. Hence any impact on the independence and quality of a PIE's audit would seem remote.

Cross-border considerations

The situation above is further exacerbated by the fact that there are not only multiple parties within a banking syndicate, but they will often be banks from multiple EU Member States.

Whilst we appreciate the difficulty in seeking to conform the Directive/Regulation, Ethical Standards and Audit Standards in the UK, we do however think it is important to seek to achieve a consistent interpretation of the Regulation across different Member States so that banking syndicates are not faced with uncertainty regarding which rules to apply when faced with a syndicate consisting of a variety of different lenders from across the EU.

Conclusion

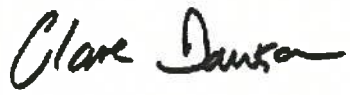
We believe that the situation we are raising comes in the category of potential unexpected consequences of the Directive and Regulation. We believe that this needs to be addressed to avoid the potential restriction of choice in the market that could arise in terms of a syndicate's ability to select an appropriately skilled and credentialed professional advisor to provide non-audit services.

We would encourage the FRC to work with its European counterparts to seek to achieve a simple and consistent application of the Directive/Regulation, as far as possible, with similar clarity of interpretation.

We would be happy to discuss any aspect of this response with you in more detail. If we can be of any further assistance, please do not hesitate to contact me via email at clare.dawson@lma.eu.com or by telephone on 020 7006 2216. Alternatively my colleague

Amelia Slocombe may be contacted by email at amelia.slocombe@lma.eu.com or by telephone on 020 7006 4114.

Yours sincerely



Clare Dawson
Chief Executive
Loan Market Association