



Turning Off the Liquidity Tap: the consequences of a no deal Brexit on the European loan market

1. INTRODUCTION

This paper has been produced in response to concerns by LMA¹ members that the UK may withdraw from the EU without concluding a withdrawal agreement under Article 50 of the Treaty on European Union and without agreeing an appropriate transition period to enable market participants adequate time to adjust to the resulting legal and regulatory environment.

The aim of the paper is to emphasise the number of regulatory issues which could arise in a lending context as a

result of a “no deal” scenario, and the negative repercussions that this would create for the wider EU economy. The LMA believes that the risk of substantial market disruption is more likely in view of:

- the wide usage of wholesale loan products across the EU27;
- the cross-border nature of lending;
- the differences in loan market regulatory requirements between individual EU member states (“**Member States**”); and
- the heavy reliance of borrowers on the loan product for their day to day business needs.

It should be noted that the focus of this paper is on the impact of a “no deal” Brexit scenario on lending to borrowers located in EU 27 countries by UK lenders, and not the other way around. This is on the basis that the UK government has proposed legislation to

put in place temporary permissions and recognition regimes which would allow EU27 institutions to continue their financial services activities in the UK for a limited time period after the UK’s departure from the EU, even if there is a “no deal” scenario and no transition period. Furthermore, it has confirmed that for EU27 institutions wishing to maintain their UK business on a permanent basis, the temporary permission regime would provide sufficient time to apply for full authorisation from UK regulators. In addition to the temporary permission regime, the UK regulators have been granted the power to implement transitional provisions phasing in any changes to UK firms’ obligations arising as a result of Brexit. As a result, the UK regime should already have the flexibility to provide for transitional provisions addressing the majority of the concerns described in this paper.

¹ 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 700 organisations across 64 countries and consists of banks, non-bank investors, law firms, rating agencies and service 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.

2. EXECUTIVE SUMMARY

The regulation of loan market activities - including who can be a lender and who can own/acquire/sell a participation in a loan (whether at par or in a distressed scenario) - varies significantly from country to country within the EU. This means that there are some countries where a person² may be a lender without any particular regulatory requirements being imposed upon it, but others where only entities who are locally authorised or passported may engage in this type of business. Consequently, any loss by UK lenders of EU passporting rights - which include lending, as well as other forms of financing (including guarantees) - will have a major impact not only on loan market activities conducted by institutions located in the UK, but also on borrowers benefiting from UK-sourced liquidity across the EU27. Whilst some of this liquidity may be capable of being transferred (e.g. to appropriately authorised affiliates located in the EU), the shorter the time available for any transfer to take place (or for any new authorisations to be obtained in the event that this is not possible) the lesser the likelihood that this process will be completed in an effective and efficient manner, and without the potential for systemic risk across the financial system.

Furthermore, and separate from any regulation impacting lending itself (or the act of subsequently acquiring/divesting of a loan interest), there exists additional EU regulation which could have a wider impact on the decision to lend or the lending process more broadly. This includes, for example, the treatment of "exposures" under the Capital Requirements Regulation ("**CRR**"), the use of UK credit ratings for asset risk-weighting purposes and the ability

to hedge exposures under wholesale loans using OTC derivatives. The impact of these broader regulatory measures is such that, even if lending itself is permitted in a particular jurisdiction, other contributing factors could lead to such lending not being practical, cost effective or otherwise possible. This is particularly likely in the context of syndicated lending³, where other ancillary banking products and services are often provided as part of a financing "package". Given the volume of lending which emanates from the UK to borrowers located in the EU27, this would result in a diminished pool of available liquidity, as well as a less competitive and possibly more costly lending environment.

By way of illustration, between 1 November 2017 and 31 October 2018, UK lenders provided a total of €30.3 bn of syndicated loan financing to borrowers located within the top seven EU27 countries (excluding the UK). This figure increases to €40.4 bn when considering all EU27 countries. In the Netherlands, for example, UK lenders financed 16% (€5.5 bn) of total syndicated loan volumes. UK lenders also contributed 13%, 10%, 14% and 8% of total syndicated loan volumes to borrowers located in France, Sweden, Belgium and Germany. Looking at the reverse position, €32.2 bn (28.8%) of UK syndicated credit is provided by EU27 institutions⁴. These figures outline the reliance of both borrowers and lenders on intra-EU cross-border capital flows in order to finance both UK and EU-based syndicated loan transactions.

In view of the above, we believe that it is vital that transitional arrangements are put in place, so that borrowers are adequately protected irrespective of the manner of exit of the UK from the EU. This will prevent unnecessary economic

instability and ensure the preservation of existing financing arrangements. This is also especially important given that there is no "equivalence regime" for cross-border lending or credit services or indeed associated activities such as payments and deposit-taking. However, as illustrated earlier, these are all services that are currently widely used and relied upon across the EU.

3. LENDING AND THE EU REGULATORY ENVIRONMENT

There are numerous issues which arise when considering the need for, and the importance of, transitional arrangements in a syndicated loan market context. The first of these arises in relation to licensing, and the ability to do cross-border business, in respect of both new and existing customers (i.e. loan agreements in place at the time of the EU exit). The second arises in relation to the loan contract itself and ensuring its continuing validity, effectiveness and enforceability. The third relates to ancillary issues outside of core lending activity, but which might impact the decision or ability of an institution to lend. Adapting to these issues is likely for many UK-based lenders⁵ to take a significant amount of time and analysis and furthermore may not be entirely obvious until some time after exit date. Transitional arrangements are therefore in the interest of all parties to avoid any damaging and potential "cliff-edge" effects in the event that a "no deal" situation arises. Finally, as has been already noted, "lending" in respect of a syndicated loan arrangement does not exist in isolation, but is often part of a wider "financing package" consisting of numerous other financial products and services (such as hedging, account bank services etc). Furthermore, this "package" may be offered on the same

² It should be noted that different authorisations may also be required (or may not be available) depending on the nature of the lender (e.g. whether it is a bank, insurance company, fund or other type of non-bank institution).

³ A syndicated loan facility may encompass a single loan facility or a variety of different facilities, making up a total facility commitment. Most commonly, this will constitute a term loan and/or a revolving credit facility, but may also include a swingline facility, standby facility, letter of credit facility, guarantee facility or other similar arrangements. Whilst the underlying instruments may differ, however, the structure of a syndicated loan is always the same - 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 or borrowing group will typically appoint one or more entities as "mandated lead arranger(s)" (the "**MLA**"). The MLAs will then proceed to sell down parts of the loan to other lenders (the "**Lenders**") in the primary market, whilst often retaining a proportion of the loan itself/themselves. The arrangement is put together under one set of terms and conditions, with each Lender's liability contractually 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 Lenders to participate in facilities of various amounts, well in excess of the credit appetite of a single Lender.

⁴ Source: Dealogic.

⁵ It is important to note that UK-based lenders include, not just lenders whose main business is in the UK but also, businesses headquartered elsewhere (such as non-EU businesses) who have chosen to base their European business in the UK, in part because of access to EU passporting rights.

terms to all or certain other entities within the wider borrower group (and across different jurisdictions). This can create two potential problems in the event of a “no deal” situation: 1) even if the act of lending, acquiring or selling a loan is appropriately authorised, the ancillary products and services may not be; and 2) even if all products and services are appropriately authorised in the jurisdiction of the principal borrower, it may be that they can’t subsequently be offered to certain of its subsidiaries within the corporate group. This kind of result could, in turn, make it incredibly difficult for borrowers to manage their day to day business operations.

A diagrammatic illustration of this is set out in Annex 1 to this paper.

4. LICENSING - NEW BUSINESS

The exit of the UK from the EU means that a large number of banks incorporated and authorised in the UK will no longer benefit from a passport to provide the cross-border services covered by the Capital Requirements Directive (“CRD”) (which includes lending) from the UK into the EU27. The CRD does not provide for a harmonised third country regime allowing non-EU banks to provide these services on a cross-border basis to customers in the EU, but rather leaves the regulation of cross-border services by non-EU banks to the national law of each Member State. Therefore, in a “no deal” scenario, UK-based banks looking to continue to provide these services to customers in the EU27 would face differing licensing regimes across the EU27 and may be subject to a wider range of local requirements when conducting that business.

As has already been outlined, the approach taken by individual EU27 Member States to licensing these services varies significantly. Some Member States do not impose licensing requirements on all these services, whereas others impose requirements but do not significantly restrict cross-border business or provide exemptions or licensing regimes which allow non-EU banks to provide cross-border services to customers in their territory. However, a significant number of Member States have strict rules requiring entities providing deposit-taking, credit, payment and foreign exchange services to either obtain a local licence or to benefit from a passport, in ways that would, in practice, prevent UK-based banks seeking new

business from local customers, in some cases including existing customers. This would significantly disrupt the ability of UK-based banks to continue to provide cross-border services to customers in these Member States from the UK.

Finally, it should also be emphasised that EU cross-border lending is not limited purely to banks. Loan market participants come in a wide variety of forms, including CLOs, investment firms, debt funds and insurance companies, with such entities becoming increasingly established providers of loan market liquidity. The same issues described above in relation to banks will also apply to these non-bank entities: there is no harmonised third-country regime under EU law that would permit these entities to continue to provide cross-border services to EU27 borrowers and so they will also be subject to the restrictions and requirements that apply in each Member State.

Proposed solution: we believe that there is no sound basis for immediately excluding those entities which are established in the UK from continued access to EU borrowers, and therefore in preparation for a “no deal” Brexit, we welcome the steps being taken by governments and regulators in some Member States to support some continuity of access post Brexit.

We would, however, urge the European Commission and the European Supervisory Authorities to seek to co-ordinate these efforts and encourage further dialogue between the regulators.

5. LICENSING - EXISTING BUSINESS

5.1. Direct loan investment

In those jurisdictions where authorisation is required in order to lend or acquire loans, the issue of what happens when the lender ceases to be authorised during the life of the loan is unclear. This is relevant both to fully drawn loans and those that are undrawn or partially drawn. There is therefore a risk in some jurisdictions that where the lender benefits from an EU passport, if that entity ceases to be passported whilst the loan is still outstanding, the loan itself may be legally vulnerable or subject to repayment/restructuring.

Proposed solution: we would urge that loans originated or acquired by passported firms at a time when those firms were validly authorised should not

be affected by the loss of any passport rights of those firms. This constitutes, in effect, a grandfathering of rights arising under such loans.

We understand that governments and regulators in a number of Member States are considering legislation that would permit UK firms to continue to provide regulated services under agreements entered into prior to Brexit, and we would urge the European Commission and the European Supervisory Authorities to seek to co-ordinate these efforts and encourage greater dialogue between the regulators.

5.2. CLO investment

Investors in loan assets frequently invest in pools of loans rather than on an asset-by-asset basis. These pools generally contain a credit support element and are therefore classed as securitisations. They are referred to in the market as Collateralised Loan Obligations (“CLO”) issuers. European CLOs are widely held amongst EU and global investors.

The CRR requires EU investors in CLOs to ensure that they only invest in CLOs where there is a minimum risk retention by the sponsor, originator or original lender of the assets (the “skin in the game” requirement). However, this requirement is only satisfied where the risk is retained by a MiFID-authorised entity. This raises the question of what the position is, or should be, where an investor holds a CLO issued by a vehicle whose sponsor, originator or original lender is a UK firm which ceases to be MiFID authorised by reason of the UK leaving the EU. In such a case, the sponsor would presumably continue to hold the risk retention element of the portfolio, but arguably EU investors in such assets would be required to divest them, since they would no longer satisfy the requirement that the retention be held by an authorised firm. Given the volume of CLO investment held by EU investors, a wholesale divestment of this nature would have the potential to generate unnecessary systemic risk.

Proposed solution: we would stress the importance of ensuring that transactions which would have satisfied the requirements of EU law but for Brexit should be regarded as continuing to satisfy those requirements until the maturity of the CLO investment vehicle.

As mentioned earlier, we urge the European Commission and European Supervisory Authorities to co-ordinate the efforts being made by Member States to ensure continuity of services post Brexit.

6. THE USE OF INTERMEDIATION PRACTICES

Intermediation is the generic term used to describe an arrangement whereby a non-EU entity does business with an EU counterparty through a separate EU firm. Typically, in the loan market, a non-EU bank may lend to an EU borrower through an authorised EU entity which has the appropriate authorisations. That EU entity may be (but need not be) a member of the same group as the lender.

Intermediation structures have been used in the EU loan market for many years, and their operation is reasonably well understood by the national regulators in those jurisdictions in which lending is regulated. We would not expect the position as regards intermediation to be different for UK firms post-Brexit than it is, for example, for US lenders today - that is, a structure which works for a US bank in the EU at the present time should work equally well for a UK bank in the EU post Brexit.

Proposed solution: it is important that EU Member States do not use Brexit as a reason to change current rules as regards the provision of credit and other financial services by third-country entities to EU borrowers. Such a re-visitation would potentially disrupt established practices, as well as impeding new business, and we believe that remaining Member States should continue with the domestic policies which they have already established post Brexit.

7. CHOICE OF JURISDICTION CLAUSES AND ENFORCEABILITY OF JUDGMENTS

A large proportion of syndicated loans in the European market are governed by English law, and these loans are therefore generally transferred under English law. This is because market participants have come to rely on English law as a common vernacular for loan transactions.

Any disturbance of this regime would create commercial problems for lenders and borrowers alike. Preservation of the recognition of English law and English jurisdiction is therefore critical.

English commercial contract law is largely unaffected by EU law and so the UK's withdrawal from the EU will, in principle, not affect this position. This is on the basis that the courts of Member States will continue to give effect to English law in the same way as they do currently. This is a function of the Rome I Regulation which requires EU member states to give effect to the parties' choice of law, regardless of whether that law is the law of an EU member state or the law of another state.

However, a "no deal" scenario could affect the extent to which a judgment of the English courts will be enforceable in other EU Member States - this will depend upon the terms agreed with the EU in relation to such a withdrawal. At one end of the spectrum is the possibility that there is no agreement - that would leave English judgments in the same position to that of, for example, New York judgments, whose enforceability in a Member State depends on the domestic law in that Member State. At the other is the possibility that arrangements for EU-wide automatic recognition of English judgments could be agreed. Therefore, there is an issue as regards the fact that UK judgements will not be automatically recognised in the EU post-Brexit in the event of a "no deal".

Proposed solution: with regards to ensuring that judgments are effective, there are a number of possibilities. These include: (i) the UK's accession to the Hague convention which would give effect to exclusive jurisdiction clauses only and provide for enforcement of the resulting judgment; (ii) the UK's accession to the Lugano convention which would allow enforcement of an English judgment in the EU; and (iii) a similar arrangement to the Brussels I Regulation agreed between the UK and the EU.

Separately to this, both the UK and the EU should seek to ensure that there is continuity of treatment for existing agreements, so that lenders and borrowers under existing facilities can be confident that their rights against each other will not be affected.

8. ANCILLARY REGULATORY ISSUES OF CONCERN

8.1. Exposures to UK entities

Under the CRR, exposures to third-country investment firms and credit institutions may be treated as exposures to "institutions" (and thereby benefit from

preferential regulatory capital treatment) only if the third country applies prudential and supervisory requirements to that entity that are at least equivalent to those applied in the EU. The Commission may adopt a decision as to whether a third country applies equivalent prudential and supervisory requirements.

Once the UK becomes a third country, EU27 institutions may no longer be able to risk weight exposures to UK institutions and other UK entities arising from lending activity in the same way that they do currently (e.g. they may have to risk weight exposures to UK banks and investment firms as exposures to UK corporates). As a result, EU27 institutions may be subject to increased capital requirements in respect of existing and future contracts with UK counterparties. This has the potential to create unnecessary uncertainty, and the potential for systemic risk.

Proposed solution: the Commission could address this by amending Implementing Decision (EU) 2016/2358 to extend it to cover UK institutions and other UK entities.

Similar issues arise under prudential regulation in relation to other entities (e.g. Solvency II for insurers). We would urge the Commission to take all relevant steps to ensure that EU27 entities may continue to treat UK exposures as EEA exposures, to avoid increased capital requirements that do not reflect any increase in risk.

8.2. Contractual recognition of bail-in clauses under the Bank Recovery and Resolution Directive (BRRD)

Article 55 BRRD requires firms subject to BRRD to include a term in agreements governed by the law of a third country, under which their counterparty recognises that any liability created under that agreement may be subject to write-down and conversion powers exercised by a resolution authority under BRRD. This term is not required where the resolution authority of an EU Member State determines that the liabilities under the relevant agreement can be subject to write-down and conversion powers under the law of the relevant third country or pursuant to a binding agreement concluded with that third country.

In the event of a no deal, English law will become the law of a third country, and so firms subject to BRRD will be required to include contractual recognition of bail-in clauses in English law loan documents that create liabilities for those firms. Given the large number of contracts governed by English law entered into by EU firms subject to BRRD, the process of including such clauses is likely to be hugely cumbersome, with arguably limited benefit from a regulatory perspective.

Proposed solution: Article 55(1) states that the requirement to include bail-in clauses “*shall not apply where the resolution authority of a Member State determines that the liabilities or instruments... can be subject to write down and conversion powers by the resolution authority of a Member State pursuant to the law of the third country or to a binding agreement with that third country*”.

If the UK retains its current provisions implementing Articles 94 and 95 of the BRRD, and as part of any withdrawal from the EU extends those provisions to recognise EEA resolution actions, this disapplication of the Article 55 Requirement is likely to be triggered.

We would welcome confirmation from the Commission or the EBA that EU27 firms will not be required to include bail-in clauses in agreements which were entered into prior to the UK’s departure from the EU and which do not qualify as MREL.

8.3. Use of UK credit ratings

EU27 institutions will no longer be able to use UK credit ratings (or third country credit ratings currently endorsed in the UK) for capital purposes (e.g. to risk weight exposures under lending arrangements, for qualification of credit risk mitigation or for the calculation of the CVA charge) unless the ratings are endorsed by an EU27 credit rating agency or certified in the EU under the Credit Risk Agency Regulation (“**CRA Regulation**”). Ratings provided by third country rating agencies can only be certified if the Commission has adopted a decision that the relevant third country’s regulation of credit rating agencies is equivalent to that under the CRA Regulation.

If the UK is not determined to be equivalent, EU27 institutions using UK ratings for capital purposes may be subject to increased capital requirements in respect of existing and future contracts

with UK, EU27 and rest of world counterparties. This has the potential to create unnecessary uncertainty, and the potential for systemic risk.

Proposed solution: EU27 institutions could continue to use UK ratings if the Commission adopted a decision on the equivalence of the UK regulation of credit rating agencies to the CRA Regulation, and if the UK credit rating agency that produces the ratings applied to ESMA for certification and satisfied the conditions for certification.

Since the UK’s proposed legislation onshoring the CRA Regulation is already available, we would urge the Commission to start the process for assessing equivalence as soon as possible and for ESMA to work with the FCA to enter into the necessary cooperation arrangements.

In the absence of a Commission equivalence decision, EU27 institutions could also continue to use UK ratings if an EU27 credit rating agency obtained permission from ESMA to endorse a UK or other third-country rating. However, that EU27 credit rating agency would need to satisfy the conditions in the CRA Regulation, including the requirement for there to be an objective reason for producing the rating outside of the EU and endorsing it for use in the EU.

8.4. Use of UK benchmarks

EU27 supervised entities will no longer be able to use benchmarks provided by UK administrators in new financial instruments after 1 January 2020.

This will not affect wholesale lending directly, as the only lending activity directly subject to the restriction is consumer credit and consumer mortgage lending. However, the restriction may affect firms’ ability to hedge exposures under wholesale loans using OTC derivatives and may also affect the appetite of EU27 supervised entities to enter into loans referencing UK benchmarks.

Proposed solution: EU27 supervised entities would be permitted to use UK benchmarks if the benchmarks and their administrators were included in ESMA’s list of permitted benchmarks.

The most straightforward route would be where the Commission has adopted a decision that the UK regulation of benchmarks is equivalent to the BMR. Since the UK’s proposed legislation onshoring the BMR is already available,

we would urge the Commission to start the process for assessing equivalence as soon as possible and for ESMA to work with the FCA to enter into the necessary cooperation arrangements.

In the absence of a Commission equivalence decision, UK benchmark administrators would need to apply to the relevant EU27 competent authority for recognition of their benchmark, or would need to find an EU27 entity to endorse their benchmark for use by EU27 entities. We understand that there are significant difficulties with both of these regimes which may result in key benchmarks no longer being available to EU27 entities if there is no Commission equivalence decision in relation to the UK.

8.5. Collateral and netting

The EU collateral and Settlement Finality regimes provide an EU-wide set of rules protecting collateral and netting rights. We expect both the UK and the EU27 to be keen to preserve the effectiveness of arrangements of this kind, and we therefore expect national legislation protecting such rights to continue in force both in the UK and in the EU27 countries. However, the fact that two separate regimes will exist will raise questions as to whether the related rights in the EU27 are available to non-EU27 collateral takers.

Proposed solution: agreement should be reached between the UK and the EU27 confirming that collateral and netting rights will be available to entities regardless of their place of incorporation.

8.6. GDPR and data transfer

There remains a high degree of uncertainty surrounding the transfer of personal data between the UK and the EU27 post Brexit. After leaving the EU, the UK, as a third country (and unless separately agreed) would no longer be part of the EU “safe data” zone under GDPR. This will make any transfer of data between the EU27 and the UK more complex. The transfer of data between the parties to a syndicated loan arrangement, as for other banking services, is a vital aspect of achieving a seamless cross-border service.

Proposed solution: if a third country is deemed to have an “adequate” data protection framework in place, then data transfers between the EU and that third country can continue without restriction. However, due to the nature of the equivalence regime, a full assessment may only take place after Brexit. We

would therefore urge that adequacy determinations take place as soon as practicable and ahead of the UK's departure from the EU. We also urge the appropriate authorities to provide appropriate transition processes to make sure that there is no gap following the UK's departure.

9. CONCLUSION

Whilst it is understood that loan market participants will need to adapt to a different legal and regulatory environment post Brexit, given the reciprocal economic benefits of the loan product across the EU, it is important that this product is not unnecessarily impacted in the event of a "no deal" scenario. We would therefore advocate the imposition of transitional

arrangements as a matter of urgency, as any gap or delay in such arrangements being in force could have hugely negative consequence, not just on EU borrowers, but in relation to the wider EU economy.

Annex 1

As part of many syndicated loan arrangements, borrowers require access not only to the syndicated loan itself to satisfy their borrowing requirements, but an integrated "package" of products and services provided by both its syndicate lenders and potentially other specialist providers (as illustrated below). Without appropriate transitional arrangements being put in place to ensure ongoing access to the full range of products and

services, borrowers may find themselves in a difficult situation if a particular product becomes illegal post Brexit for a particular party to provide. Whilst more sophisticated borrowers may well have the ability to obtain these products and services elsewhere, others may not have the same degree of flexibility. It should also be noted that loan market liquidity is provided not only directly via the syndicate lenders themselves, but indirectly by different third parties. This type of liquidity is achieved in a variety of ways, whether it be via secondary trading of the loan itself, the purchase by the lender of a credit risk insurance product, or investment into a vehicle such as a CLO.

