

19th October 2017

The European Union Select Committee
House of Lords
London
SW1 0AA

Dear Sirs,

Submission to the 'Brexit: deal or no deal' Inquiry

In response to the House of Lords inquiry 'Brexit: deal or no deal', this letter sets out the need for, and importance of, transitional arrangements for the loan market following the EU exit of the UK.

The LMA is the trade body for the syndicated loan markets in Europe, the Middle East and Africa ("EMEA") and was founded in December 1996 by banks operating in these markets. 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 670 organisations across EMEA and consists of commercial and investment banks, institutional and other non-bank investors, law firms, rating agencies and service providers.

1. Is a transition arrangement a necessary component of any lasting agreement, and if so, why?

The regulation of loan market activities – both as to who can be a lender, and who can own a loan participation – varies significantly from country to country within the EU. Consequently, there are some countries (such as the UK) where a person may be a lender without any particular regulatory requirements, but others (such as France) where only banks who are locally authorised or passported may engage in this business. This means that the loss of the CRD passport – which covers lending – will have a major impact on some lending and loan market activities conducted by banks in and through the UK, unless mitigating measures are agreed, including a transitional period following exit from the EU.

There are two significant groups of issues which arise in considering the need for, and the importance of, transitional arrangements. The first of these arises in relation to licensing, and the ability to do cross-border business, in respect of both existing business (i.e. agreements in place at the time of the EU exit) and future business. The second arises in relation to the loans themselves, and ensuring their continuing validity and effectiveness.

Adapting to these issues is likely for many lenders to take a significant amount of time. As a consequence, a sudden withdrawal of passporting rights could affect both the enforceability of

existing loan agreements and the ability and willingness by UK-based lenders¹ to enter into future agreements. Transitional arrangements are required to avoid these damaging effects.

Public commitment to agreeing transitional arrangements will be important. In the absence of such a commitment, UK-based lenders will need to proceed with their Brexit planning on a "prepare for the worst" basis, having to assume that there will be no transitional arrangement. This could lead to UK-based lenders withdrawing lending activity, as well as existing agreements being affected, prior to the EU exit.

In 2016, UK banks² provided €46.4bn in syndicated loan volumes to borrowers in the EU27.³ Cross-border lending activity is of significant importance to UK banks to expand outside of the UK's domestic market and for European borrowers to access a greater pool of loan financing in a more open and competitive environment. During the same period, EU banks⁴ funded €41.5bn, i.e. 29.71%, of total syndicated loan financing to UK borrowers.⁵ There is a clear mutual need between the UK and EU27 to satisfy borrowers' lending requirements in each region.

2. What will be the key components of a transition arrangement?

Licensing

The exit of the UK from the EU means that banks incorporated and authorised in the UK would no longer benefit from a passport to provide the services covered by the CRD cross-border licence from the UK into the EU27, including lending. It also includes other forms of financing (including guarantees), financial licensing, payment services as well as corporate finance advisory services.

The CRD does not include a third country regime allowing non-EU banks to provide these services cross-border to customers in the EU. Therefore, in the absence of any mitigating steps that might be negotiated as part of the UK's exit, UK-based banks providing these services to customers in the EU27 would face, following the EU exit, differing licensing regimes across the EU27 and may be subject to a wider range of local requirements when conducting that business. In the absence of any transitional arrangements, those differing licensing regimes will apply to UK-based banks on exit.

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 exemption or licensing regimes which allow non-EU banks to provide cross-border services to customers in that territory. However, a significant number of Member States have strict rules requiring entities

¹ 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.

² UK banks includes banking institutions incorporated and authorised in the UK.

³ Source: Dealogic

⁴ EU banks includes banking institutions incorporated and authorised in the EU. This does not include UK banks.

⁵ Source: Dealogic

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 disrupt the ability of UK-based banks to continue to provide services to customers in these Member States by providing cross-border services from the UK.

These requirements are relevant to fully-drawn loans, and raise the question of whether a fully-drawn loan agreement entered into legitimately by a UK-based bank under the CRD passport would continue to be enforceable if the CRD passport is no longer available. The requirements also apply to undrawn or partially drawn facilities and question whether a further extension of credit by a UK-based bank under a revolving credit facility would be permitted. The consequence of breaching the EU27 licensing requirements can be a criminal or civil offence, leading to regulatory sanctions and affecting the enforceability of loan agreements.

A number of EU countries maintain a separate regulatory regime for non-bank finance companies. These regimes prevent firms from entering into certain financing activities unless they are separately authorised. The CRD also contains a passport regime for finance companies. This permits unauthorised subsidiaries of EU banks (established in countries where their activities are unauthorised) to engage in these activities without restriction provided that they are subsidiaries of authorised EU credit institutions. Unregulated subsidiaries of UK credit institutions also rely on this passport in order to conduct these activities in EU countries.

In the absence of any transitional arrangements, or if there is a gap between EU exit and a transitional arrangement being in force, UK-based lenders will need as part of their Brexit implementation to plan on the basis that no transitional arrangement will be in place. This implementation could include the move of lending business into new EU27 based vehicles (which is likely to be capital intensive and expensive) and/or UK-based banks withdrawing lending activity.

Preservation of existing transactions

As previously noted, in those jurisdictions where authorisation is required in order to make or own loans, the issue of what happens where the lender or loan owner ceases to be authorised during the life of the loan is unclear. This is relevant both to fully drawn loans and undrawn or partially drawn loans. There is therefore a risk in some jurisdictions that where the lender or loan owner is a UK passported bank, if that entity ceases to be passported whilst the loan is still outstanding, the loan itself may be legally vulnerable. Such legal uncertainty creates the potential for legal disputes. Moreover, UK-based lenders would begin as part of their Brexit implementation planning to work on the basis that they will not be able to meet obligations under some existing loan business, which would mean that business would need to be restructured and/or the UK-based bank would need to consider the viability of that business.

Many UK-based banks and investment firms have established branches in the EU27 using their passport rights under CRD and MiFID. There is no harmonised EU regime for the treatment of EU branches of non-EU banks and investment firms. Member States may choose to authorise these branches, but must not treat them more favourably than branches of EU firms. Therefore, the UK's exit from the EU could, unless legislative action is taken, lead to banks being required to cease

business in those branches unless and until they can be relicensed under the domestic regime in the Member State where the branch is located. The impact on existing loans made by those branches will require further analysis by relevant lenders.

3. *How will the UK-EU relationship be conducted during the transition period? How long should the transition period last?*

The issues outlined above may take a significant amount of time for UK-based lenders to adapt to and the length of the transition period should reflect this. Brexit planning will currently need to proceed on a "plan for the worst" basis (working on the assumption that there will not be a transitional period). In practice, this will mean implementing Brexit structuring and business responses prior to the date of the EU exit (to ensure that all relevant steps have been taken by the point of EU exit), which could include withdrawing lending activity and/or implementing costly new lending structures. Public acknowledgement that a transitional arrangement will be part of the EU exit will be important in ensuring such negative outcomes do not crystallise prematurely or permanently.

It is important that any transitional arrangements are treated as separate from the overall EU exit agreement so as to focus on the transitional arrangement being in place at the point of the EU exit of the UK, as any gap or delay in a transitional arrangement being in force could have the same negative consequences outlined above. This will also limit the impact that the terms of a transitional arrangement might have on the features and terms of the future agreement between the UK and the EU.

The transitional arrangement should be as broad as possible to ensure that the fullest range of rights and obligations remain available for discussion as part of the future UK-EU agreement. In respect of licensing, we would consider that this should include (for the loan market) the continuing right for UK banks and non-banks to make and own loans to EU27 entities. In respect of preservation of existing transactions, the transitional arrangements should provide that loans originated or acquired by passported firms at a time when those firms were validly authorised should not be affected by the termination of those rights of those firms.

We hope the above is useful. If we can be of any further assistance, or if you have any additional questions, please do not hesitate to contact me by email at nicholas.voisey@lma.eu.com or on 020 7006 5364.

Yours faithfully,

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