LMA & LSTA Conference Summary (30 March 2022)

On the 30th of March 2022, the LMA and LSTA held their joint annual conference at the offices of Allen & Overy in London. We are delighted that over 300 industry professionals attended, joined by experts who delivered sessions covering the current economic and geopolitical outlook for the loan market, a comparison between trends in the US and European loan markets, insights from direct lenders, developments in sustainable finance, LIBOR transition, and updates on recent regulatory and sanction developments.

Session 1: Global Economic Outlook

Current volatility in the financial markets was predicted to continue in light of the ongoing war in Ukraine, the biggest European conflict since 1945. It was noted that the war in Ukraine had led so far to rising inflation, escalating oil prices, and the weakest Russian rouble since the invasion of Georgia in 2008. It was also expected to exacerbate existing supply chain issues, which were continuing following the Covid-19 pandemic.

It was noted that, post pandemic, slow growth, coupled with low inflation, had been widely anticipated. The current high inflationary environment was not therefore expected to persist in the longer-term. However, the outbreak of war was likely to prolong this trend, and inflation was now predicted to peak close to 10%. It was further noted that significant slowdowns may take place across world economies as a result of current geopolitical and macroeconomic issues.

Meanwhile, it was noted that cryptocurrencies had grown exponentially over recent years, and were becoming a growing area of focus for policy makers and regulators globally. Cryptocurrencies looked increasingly likely to be brought further into the regulatory sphere in both Europe and the US.

Finally, it was noted that carbon pricing looked to be here to stay, and would be likely to have a vital role to play in reaching net zero targets. Carbon pricing had so far created, and continued to create, opportunities for channelling capital into sustainability. Green investments and carbon capture technologies were predicted as being likely to continue to attract interest as the focus on sustainability in the market continued to grow.

Session 2: US/UK Loan Markets: Trends and Insights

2021 was viewed as a strong and robust year for the loan market on both sides of the Atlantic. In terms of leveraged lending, the US saw loan volumes of US$1.35 trillion, the second highest volumes on record since 2017, and EMEA saw volumes of €272 billion, the highest EMEA volumes since the financial crisis.

In Western Europe, loan issuance had increased 54% compared to 2020, despite the dual shock of the pandemic and high inflation. This rapid growth could be attributed largely to optimism surrounding the vaccine rollout and the general bounce back from the pandemic. Historically low financing rates had enabled low-cost high-yield deals, and had also led to an increasingly active collateralised loan obligation (**CLO**) market, which had seen issuance hit US$183 billion in the US and €32.3 billion in Europe in 2021.

The sponsor market, which had a backlog of liquidity at its disposal following a period of stagnation in 2020, had also been more active in 2021. An uptick in refinancing and leveraged buy outs (**LBOs**) had contributed to record volumes in 2021. Additionally, institutional loan issuance in 2021 had totalled US$790 billion in the US, the highest since 2017, and €167 billion in Europe. 2021 had also seen a robust year for secondary loan trading, with a record US$780 billion in US trading volumes.

Default rates had reached a 10-year average low of 0.29% in the US and 0.6% in Europe. These unusually low default rates were, however, likely to increase through 2022 as businesses returned to normal trading post-pandemic. Whilst 2021 had seen relatively low volatility levels across markets, it was noted that the same could not be said of 2022. To date, loan issuance was down 48%. Recent reports had suggested that the impact of the war, although blunted somewhat by global fiscal measures, would likely filter into the loan market through rising inflation, financial disruption (for example, due to restrictions on cross-border payments), and risks to security.

Market trends

2022 had so far largely seen a return to secured capital structures and second liens due to their efficiencies over subordinated bonds. Direct lenders had also been heavily involved in recent LBOs due to their competitive pricing, which had undercut the syndicated term loan B market. There had also been an increase in the share of private equity (**PE**) in the global mergers and acquisitions market, and PE firms were therefore expected to have more influence in the market throughout 2022.

Covenants

In the US, longer term trends continued to favour borrowers, but there had been largescale pushback from lenders on certain credit agreement loopholes. In Europe, there continued to be sponsor-side lawyer innovation in the loan market, although again there had been a tightening of credit agreement loopholes and commercial terms through the pandemic.

It was noted that management teams were regularly making commitments across ESG pillars, and the importance of investors knowing and understanding ESG issues was now viewed as paramount. With this, more ESG terms were filtering into credit agreements.

Two particularly significant trends that had been observed in credit agreements were an increase in borrower controls over facilities, such as through voting caps and anti-net short lender provisions, and an increase in intra-lender conflicts particularly around subordination of lenders within bank groups.

Session 3: Growth of Direct Lending?

It was noted that recent growth in the direct lending market (**DLM**) had been significant, both in terms of the average portfolio size and average deal size. Whilst this pattern was largely mirrored in both Europe and the US, the US DLM remained more advanced than the European equivalent. Private capital was now growing at approximately 30-50% per annum globally. In 2021, PE had a record fundraising year globally also, raising US$800bn, and there was predicted to be a doubling in the size of this market over the next 4 years.

The DLM had also seen an uptick in the focus on ESG issues, including in the investment process, due to the need to ensure compliance with the Sustainable Finance Disclosure Regulation.

Session 4: ESG Disclosure – Can the loan market get what it needs?

It was noted that the European Leveraged Finance Association's (**ELFA**'s) 2021 ESG investor survey had highlighted a number of key takeaways regarding ESG. For example, three quarters of respondents said they made investment decisions based upon ESG issues. 98% of those surveyed stated that the material challenge to a comprehensive ESG analysis was data availability. Whilst improvements in this area were underway, market stakeholders must address ESG issues together moving forward.

It was noted that the ELFA had launched a set of ESG fact sheets, which had been used on loan deals. Upcoming regulation in relation to ESG disclosures were also likely to impose mandatory disclosure obligations which would be of increasing importance to investors.

The US market was still slightly behind the European market in terms of ESG disclosures, but it was noted that the US had started to factor in ESG considerations more often due to changes in the regulatory and investor landscape.

It was noted that sustainability-linked loans had led to improvements in ESG disclosures in the loan market, including through the requirement for third party verification in relation to sustainability performance targets. There were also indications of 'green shoots' emerging as market participants were starting to require ESG disclosures outside of sustainability-linked loan transactions. Nonetheless, there remained a long way to go in terms of ESG disclosures.

A new ESG harmonisation project was announced by the LSTA in collaboration with the Alternate Credit Council and the PRI, with the objective of aligning lenders and private equity sponsors in order to support material and consistent ESG data disclosure. It was noted that this project would aim to develop a harmonised ESG reporting tool for borrowers so that lenders would be able to receive consistent data from sponsored and non-sponsored borrowers across the private and broadly syndicated credit markets.

Session 5: Is disorder the new normal? Geopolitics and the loan market in 2022

Yes: Disorder was the new normal. War was the realm of uncertainty and thus war was inherently unpredictable. However, in retrospect, the war in Ukraine was not a complete surprise as over the past decade Putin had not hidden his propensity to ignore state sovereignty, as demonstrated by his invasions of Georgia and Crimea. This raised the question: to what extent should governments and businesses have prepared for this, especially as over 50% of public opinion in Finland, France, Germany, Italy, Poland, Romania, and Sweden thought there was likelihood of an invasion. This meant that we could see lenders, investors and active shareholders bringing litigation on this topic in the future.

The key questions which remained were: what is Putin's end game, and what will Ukraine demand or be willing to accept to end the war? Current public opinion appeared against sending military support, and it was instead in favour of 'economic warfare' through the route of sanctions and expulsion of Russian banks from SWIFT. Moving forward, it was noted we were likely to see ally-shoring, wherein free trade would align with national security alliances and where NATO allies were subject to less scrutiny and regulation.

The ongoing economic uncertainty had led to increased inflation, with almost 10% inflation in Spain. This was both a political and physiological phenomenon, with many concerns surrounding the impact of the Russian-Ukrainian war on global food supplies and whether this could lead to civil unrest across the world. It also raised questions of whether the economic systems in western countries required a major overhaul: over 50% of those surveyed in the US and the UK said major change or complete reform of their country's economic system was needed. These changes highlighted that there was a nationalisation risk, and this may have ESG implications moving forward, with the 'Social' component of ESG becoming increasingly political. Due to the current reliance on Russian oil, it was noted that there may also be an accelerated shift towards renewable energy in the longer term, with more short-term solutions taking the form of shale gas and fracking.

The war between Ukraine and Russia had also raised questions of what this will mean for China and Taiwan. However, it must be noted that the situation between China and Taiwan was very different from Ukraine and Russia, due to the alliances involved. This was largely due to the United States' obligations to protect Taiwan, as Taiwan was critical to US strength due to its semiconductor production. However, it was noted Beijing would be watching the current war very closely and there could be a potential flashpoint if the United States took action.

Session 6: Developments in Sustainable Finance

Recent years had paved the way for significant developments in the sustainable finance market and sustainable debt was no longer being seen as a niche market – it was now 'mainstream'. It was noted that the historical cumulative value of sustainable debt issuance had now surpassed $4.5tn, with the value in 2021 alone constituting over a quarter of this at $1.7tn (Bloomberg). It had also increasingly become the norm in Europe for credit facilities to be tied to an ESG metric, and in 2021, it was noted that more than 40% of revolving credit facilities were tied to the borrower's ESG goals (Bloomberg).

It was also noted that sustainability-linked loan instrument volumes had risen dramatically over recent few years. However, whilst sustainability-linked debt instruments had increased significantly, green loans (**GL**) had plateaued, most likely as a result of the greater flexibility offered by the sustainability-linked loan instrument.

Most attendees agreed that sustainability-linked transactions were currently setting the right level of ambition for market participants. However, it was noted that there was still work to be done in relation to key performance indicator selection and sustainability performance target calibration.

Harmonisation was highlighted by the panel to be of importance in this area - not just in terms of the ambitiousness of targets set under sustainability-linked loans, but as to the wider sustainable finance market. It was agreed that the extent to which harmonisation could occur however, was limited by the bespoke elements of each transaction.

The sustainability coordinator role was now being seen frequently on transactions both in the US and Europe. This role may fall under various labels, such as 'sustainability structuring agent' or 'ESG-coordinator', and may vary in nature on a transaction-by-transaction basis.

In relation to the 'S' (social) in ESG, it was noted that more tools were becoming available to assist the market and it was hoped that more social labelled loans would emerge in the near future. The use of social KPIs was being seen increasingly in relation to sustainability-linked loans.

Transition finance was another key topic in the sustainable finance space, in particular the urgent need to transition hard-to-abate sectors. It was noted that tools to support transition were still developing, and this was a topic the LMA and LSTA were following closely.

The sustainable finance market was expected to see significant growth in the coming years with a huge in-flow of capital into this area. Areas to watch out for included: innovation; translating regulation into action, and improving data availability.

Session 7: the LIBOR wind-down

The end of 2021 presented a significant milestone for LIBOR transition, but this should not underplay the work involved nor the achievements since, as market participants came out of 2021 in good shape. From a European perspective, the transition had gone well, but the biggest question that remained surrounded US dollars. Regulators had made it clear that there were to be no new LIBOR contracts, and it was encouraging that the first stage of transition had gone well, with the US market currently pivoting to term SOFR. Regulation, authorities, lenders and trade association efforts had made a large impact in these spheres. Moving forward, remediation of legacy contracts ought to be at the forefront of everyone's focus this year, especially now that origination was established in RFRs.

In the US market, the transition was helped by term SOFR being developed, as US cash products had been clear that they wanted a term SOFR rate and with time that need was introduced everywhere, including for loans. The position in Europe was different, as in contrast to the US, EU regulators preferred the compounded in arrears methodology, whereas the ARRC guidance was broad, allowing term SOFR to be an option. It was too early to say whether the European market would take the term SOFR route, and the challenge in this sphere was determining the right fallback. The LMA would be reaching out to its various working parties to ask them what they were seeing in the market, as this was still developing in real time.

Going into the post LIBOR phase, defining fallbacks for term SOFR was difficult. In US documentation there were two alternatives: (i) daily simple SOFR, and (ii) the amendment approach. Once loans came to the market it became clear that most loans fell back to the daily simple SOFR, and this was likely to be the case moving forward as well. The elephant in the room was the remediation of legacy US dollar loans (especially outside the US), as this was different from other currencies which had been transitioned so far and some areas had been less exposed to transition overall. The regulators had indicated that they would like these to be prioritised, and there was much work to be done on this moving forward. In response to members wanting an amendment where they did not have fallback language, the LSTA had developed generic forms of amendment to use in the US across the lending platform.

Historically, borrowers in the US have had an economic disincentive to transition, as early transition required you to apply ISDA spread adjustments. This was because RFRs did not incorporate the credit premium that LIBOR did, hence the ISDA published CAS, 5-year average difference between the two rates for each tenor. Given the fall in interest rates during the transition period, this made the ISDA-published CAS look large, rendering the transition of borrowers to a new rate a challenge and thus making it difficult to get active transition going. However, as US$ LIBOR could now be higher than the SOFR values plus CAS, it would be interesting to see if this would push borrowers to move, especially with agents and bank lenders bringing it up in every transaction. This structural issue had made it difficult for syndicates, as it was difficult to determine what a borrower wished to do. This meant that there was a lot more to be done by borrowers, regulators, and jurisdictions to resolve this issue.

Session 8: Regulatory and Sanctions Update

In December 2021, the European Commission published a new directive: The EU Credit Purchasers Directive on Non-Performing Loans (the "**NPL Directive**"). This Directive could have a significant impact on Non-Performing Loans in the secondary market moving forward, as the scope of the directive was broad and would apply to any loans originated by EU banks that then turned non-performing, inclusive of wholesale syndicated loans. Many questions remained as to how this new directive would apply to the syndicated loan market, and when the directive would bite within syndications.

On a positive note, the NPL Directive was now limited to transfers of Non-Performing Loans, the definition of which had been taken from Article 47(a) of the Capital Requirements Regulation, which discussed non-performing exposures. This was a helpful starting point as it carved out transfers in a bank's trading book, meaning that a key question moving forward would be whether the loan in question was found within a bank's trading or banking book. Assuming that a loan fell within the NPL Directive, the Directive then set out separate requirements for Credit Purchasers and Credit Servicers.

Credit Purchasers faced new disclosure and reporting requirements for banks selling Non-Performing Loans. These requirements would be elaborated by the European Banking Authority in technical standards and guidance due to be released in September 2022. Credit Servicers, meanwhile, would need to ensure they were EU established credit servicers to obtain authorisation to act by the relevant Member States. This may prove to be an issue for facility agents, as the current definition of Credit Servicer was quite broad. European Member States must ensure these requirements were implemented into national law by the 30th of December 2023.

Another upcoming development was the CRD6 Proposal, which would impact on third country regimes for banking services into the EU. This Proposal would introduce a new prohibition on non-EU firms carrying out banking services, apart from those providing services on a reverse solicitation basis. In other words, a non-EU firm could not lend into an EU Member State unless it was on a reverse solicitation basis or unless it had a branch within that Member State. It included new harmonised rules for those working within the EU and may also have unforeseen consequences for non-EU banks with branches within the EU, as these banks would not be able to carry out general banking services outside of the Member States in which they had their branches, even where the services provided were on a reverse solicitation basis. Much uncertainty remained as the Proposal was at the early stages of the legislative process, and the extent of the scope of the Proposal remains to be seen.

Finally, regarding global sanctions on Russia in respect of the Ukraine conflict, the sanctions imposed by the US, EU, and the UK were the most aligned they had ever been, with sanctions being released at an unprecedented pace with almost real-time cooperation between states. The direction of travel was out of Russia; although there were Russian sanctions in response to the sanctions levied against it, there were also broader public relations and non-legal issues driving corporate and financial institutions out of the country.

More sanctions were likely to follow, with the Biden administration implementing the Treasury's Office of Foreign Assets Control ("**OFAC**") to monitor and implement additional sanctions. Moving forward, institutions would need to be aware of who they were dealing with indirectly or directly to ensure they did not fall within the scope of these sanctions and should have a plan of action in place. Due Diligence and KYC checks must generally be risk-based, but once there was a Russian connection or "red flags" (such as the use of corporate vehicles to obscure sources of funds, use of cryptocurrency, shifting currencies, or third parties being used to shield identities, for example) then organisations would need to carry out complete due diligence checks. Key questions concerning payment of employees, intra-company transfers, and payment of taxes remained nebulous, with organisations left wondering how regulations and sanctions would apply. It was noted that such organisations should consider the action they could take within their contracts, such as considering whether they could rely upon material adverse change and/or frustration clauses.