The numerous regulatory and legislative regimes which are currently before us, are often described as an ‘alphabet soup’. This booklet (updated from the July 2013 edition) is intended to help you digest them. Spanning regulatory measures including AIFMD, Solvency II, Basel III and CRD IV, amongst others, this booklet may not increase your appetite for regulation, but it will certainly improve your understanding of the menu.
A LOAN MARKET ASSOCIATION GUIDE
REGULATION AND THE LOAN MARKET (THIRD EDITION)

Loan Market Association

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Published by the Loan Market Association

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"Regulation and the Loan Market" is not intended to be comprehensive, nor is it intended to cover every regulation which has the potential to result in consequences for the loan market and its investor base – for example, it does not consider the regulatory proposals which specifically target securitisations or derivatives. Rather, it seeks to consider those regulations which are currently seen by the Loan Market Association as having the most sizeable impact on the syndicated loan product itself, as well as the availability of liquidity within the syndicated loan market generally. Most importantly, this publication is not designed to provide legal or other advice on any matter.

The Loan Market Association

The Loan Market Association (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 600 organisations across 55 jurisdictions and consists of banks, non-bank lenders, 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 EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.
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INTRODUCTION

Loan market activities are, without a doubt, still subject to increased pressure from regulation and, over the course of the last seven years, the LMA has raised numerous concerns with regulators and government authorities regarding the sheer volume of regulatory proposals, which have hung over the market since the financial crisis first began in late 2007/early 2008. These concerns emanate largely as a result not of the underlying policy decisions which govern these new measures (of which the LMA is largely supportive) but rather the negative consequences (both intentional and unintended) that they create for both the syndicated loan market and LMA members more generally. These consequences may be seen to have arisen for the following reasons:

- much of the policy has been introduced in haste, without a full assessment of the detail or the financial products and markets to which it relates;
- there has not always been appropriate consultation of the relevant market experts (perhaps because they are seen by regulators as being biased against regulation and the root cause of the original crisis);
- the proposals have been introduced to reflect individual policy silos and have not been assessed with adequate consideration being given to their interconnectivity or their cumulative impact on the industry; and
- there has been a general lack of an integrated approach between different regulatory regimes, with national, EU and international legislation being passed unilaterally, without appropriate coordination between governments or international initiatives (such as the G20 and the FSB).

But what does this ultimately mean for the future of the syndicated loan market? First and foremost, no longer may the loan product be seen as an independently operating asset class, to which detailed regulation and macro-economic events largely do not apply – rather, the loan market is now very much in the midst of a permanently changing financial landscape. This landscape has become something which will impact the market from every possible angle, not only forcing a fundamental reassessment of the product, but also triggering concerns for loan market practices, its infrastructure, and the internal requirements, structures and procedures of its many lenders, some of whom are simply not set up to be able to implement the proposed requirements without substantial operational changes being made – something which could see them exit the market (and other financial markets) altogether.

Notwithstanding the above, the loan product has come through the regulatory maelstrom reasonably well, in no small part due to the efforts of the LMA. This has been achieved by educating regulators of the negative impact of some of their more egregious proposals.

Aim of the guide

The aim of this guide is twofold: 1) to inform loan market participants about the key regulatory proposals currently affecting the market and the manner in which they are likely to impact them individually (Sections one to four); and 2) to assess the cumulative effect of these measures and what they, as a package, could mean for the syndicated loan market going forward (Section five).
Section 1

CAPITAL, LEVERAGE AND LIQUIDITY REQUIREMENTS

A. Credit institutions and investment firms – Basel III and CRD IV

What are Basel III and CRD IV?

Basel III is a package of reforms which makes changes to the existing Basel II framework and was put together by the Basel Committee on Banking Supervision (BCBS). The term is used not only for the original restriking of the Basel capital rules after the crisis, but also for an updating programme for those rules which is still ongoing. These amendments strengthen existing capital requirements, but also introduce new prudential requirements, notably a new leverage ratio and two liquidity ratios - the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The CRD IV legislation, meanwhile, constitutes a new directive (CRD)\(^1\) and regulation (CRR)\(^2\) and has replaced the previous Capital Requirements Directives (2006/48/EC and 2006/49/EC). The introduction of both a directive and regulation as part of the revised legislation is to reflect the fact that certain provisions are to be uniform across all members states (CRR) whilst some require the ability to be interpreted more flexibly (CRD). Whilst one of the key aims of CRD IV is to implement the Basel III regime (which does not, in itself, have the force of law) it also incorporates other legislative amendments, primarily relating to corporate governance and sanctions.

When was it implemented?

Agreement on the final text of the Basel III changes was reached in March 2013. The CRR entered into force on 28 June 2013 and became applicable as of 1 January 2014, whilst the CRD entered into force on 17 July 2013 and had to be implemented by member states by 31 December 2013.\(^3\)

Who does it impact?

Whilst Basel III is aimed at "internationally active banks", CRD IV is to extend to both credit institutions\(^4\) and investment firms (i.e. firms that fall within the scope of the Markets in Financial

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\(^2\) [http://eur-lex.europa.eu/legal-content/EN/ALL;/ELX_SESSIONID=VcKI7pgZy2LKDvzH9KmHCyRhKQsvZhl9DyhQFvlrS5Qzi51TvLg!-2075090033?uri=CELEX:32013R0575](http://eur-lex.europa.eu/legal-content/EN/ALL;/ELX_SESSIONID=VcKI7pgZy2LKDvzH9KmHCyRhKQsvZhl9DyhQFvlrS5Qzi51TvLg!-2075090033?uri=CELEX:32013R0575)

\(^3\) Whilst the majority of the legislation took effect as of 1 January 2014, certain aspects of the CRD relating to capital buffers (with the exception of systemic risk buffers), and the CRR in relation to the leverage ratio, the LCR and the NSFR have/will come into force at a later date (see later on in this guide for further details).

\(^4\) A credit institution is defined as: “an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account".
Instruments Directive (2004/39) (MiFID) with some exclusions)\textsuperscript{5} regardless of whether they have international reach or not.

How will Basel III and CRD IV impact the syndicated loan market?

Basel III and CRD IV will have a variety of impacts specific to the syndicated loan market. However, it should be noted that the current position represents significant improvements for the loan market when compared to the initial proposals.

1. Capital Requirements

A capital requirement acts as a buffer against future, unknown losses and is a measure of the difference between the value of an institution's assets and its liabilities. By contrast, expected losses are covered by specific reserves or provisions. The qualifying capital of banks consists of equity and other types of financial instrument that have the ability to become available quickly to support a bank during times of crisis. Under Basel III, a minimum amount of capital is required to protect against credit risk, market risk and operational risk. The focus of this guide is on the capital requirements for credit risk.

The formula for calculating capital requirements under Basel III and CRD IV is as follows:

\[
\text{qualifying capital} \quad \text{\textasciitilde} \quad \text{required ratio}
\]

\[
\Sigma (\text{risk weighting}^6 \times \text{asset value})^7
\]

\textsuperscript{5} A small number of investment firms are excluded from the definition – see definition of "investment firm" under Article 4(8) of the CRR for further details.

\textsuperscript{6} Under the CRR, banks have the option to use standardised risk weightings (the "Standardised Approach") or to apply their own internal models (the "Internal Ratings-based Approach"(IRB Approach)), for which regulatory consent must first be obtained under Article 143. Under the Standardised Approach, risk weightings are set out in the CRR. The IRB Approach takes two forms: Foundation and Advanced. Under the former, banks estimate certain credit risk determinants and rely on the regulator for others. Under the latter, banks estimate all credit risk determinants, though the remaining maturity of loans is subject to a floor of one year and a ceiling of five years.

\textsuperscript{7} To calculate, risk weights must be applied to all of the bank's assets, including exposures to risk resulting from off-balance-sheet commitments. Measurement of risk-weighted assets is based on the allocation of weights that reflects the credit risk of different classes of counterparty. Off-balance-sheet exposures are converted to on-balance-sheet equivalents by multiplying them by credit conversion factors (CCFs). These are then weighted according to the credit risk of the class of counterparty in the same way as for on-balance-sheet exposures.

Under the Standardised Approach, risk weights are based on the exposure class to which the exposure is assigned (e.g. exposures to corporates – Article 122) and, to the extent specified, its credit quality. Under the IRB Approach, meanwhile, risk weights are calculated using banks' estimates of risk parameters (probability of default (PD), exposure at default (EAD) and loss given default (LGD)) in accordance with complex prescribed formulas. These formulas are based on modern risk management techniques that involve quantitative assessment of risk. As with the Standardised Approach, however, risk weights are still based on the relevant exposure class to which the asset is assigned (e.g. exposures to corporates, institutions and central governments and central banks – Article 153).

It is important to note that within the risk weight parameters of the CRR, competent authorities are given certain discretionary powers. For example, under the Standardised Approach, they may increase the risk weights for certain exposures e.g. for exposures secured by immovable property, risk weights may be increased to as much as 150% on the
Although the basic formula for calculating capital requirements remains the same under the new proposals as under the existing Basel II framework, each element of the above equation has been amended. Therefore, what constitutes qualifying capital has become more restricted, risk weightings have increased and the overall ratios to be met have also gone up - for example, the base requirement for common equity has increased from 2% to 4.5%, whilst the requirement for total Tier 1 capital has increased from 4.5% to 6%. Further buffers have also been introduced, and these buffers must generally be met out of equity. The directive introduces a capital conservation buffer of 2.5%, identical for all banks in the EU (Article 129 of the CRD) and an institution specific countercyclical capital buffer (set by national authorities and applicable to credit institutions that have credit exposures in the member states in which they are located) of up to 2.5% (Article 130 of the CRD).

A summary of the Basel III capital requirements is set out here:

In addition to the above, Member states are also given the power to apply a systemic risk buffer of 1% to 3% for all exposures and up to 5% for domestic and third country exposures without seeking consent from the Commission (such buffers may be increased even further if authorised by the Commission) (Article 133 of the CRD). GSIBs, as well as other systemically important institutions (OSIs) including domestic systemically important institutions, meanwhile, will be subject to yet further capital requirements (up to 3.5% for GSIBs and up to 2% for OSIs). However, the systemic risk buffer and buffers for GSIBs and OSIs (the "systemic buffers") will not generally be cumulative i.e. only the highest of the three buffers will apply. In addition, the systemic buffers will only apply to credit institutions and those investment firms authorised to deal on own account or to underwrite basis of loss experience, forward-looking immovable property market developments and financial stability considerations.
or place financial instruments on a firm commitment basis. Therefore, although the base capital requirement has remained unchanged at 8% of risk-weighted assets, the regulatory minimum for common equity has increased several times over for all banks.

**What does this mean for the syndicated loan market?**

Whilst the amended capital requirements have already had an impact on affected institutions by requiring them to increase substantially the quality and quantity of their existing capital reserves (in turn generating equivalent pressure on returns on equity) the rules also create more practical problems for the loan market itself, both from a product offering and loan due diligence perspective.

The most relevant of these relate to:

- risk weights assigned to "specialised lending exposures";\(^8\)
- risk weights assigned to trade finance exposures;
- credit risk mitigation (CRM);\(^9\) and
- counterparty credit risk (CCR).\(^10\)

Considering each in turn:

**A) Specialised lending**

Within the IRB approach, Article 153(5) of the CRR allows for a special treatment of specialised lending exposures, in cases where the institution is not able to estimate the Probability of Default (PD) or the institution’s PD estimates do not meet the requirements of the CRR. For these types of exposures, the CRR has put forward a set of supervisory risk weights, which have to be assigned on

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8 Specialised lending relates to certain types of corporate exposure under the IRB approach with special characteristics such as project finance, commodities finance, and certain kinds of real-estate finance (Article 147(8) CRR). A specialised lending exposure is effectively a loan with the following characteristics:

(a) the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure;

(b) the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and

(c) the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.

9 A technique used by an institution to reduce the credit risk (and corresponding risk weighting) associated with an exposure or exposures which that institution continues to hold (Article 4(57), CRR). CRM may take the form of either funded credit protection such as collateral or netting (Article 4(58), CRR) or unfunded credit protection such as a guarantee (Article 4(59), CRR). The funding may be provided either by the entity on whose behalf the exposure has been incurred, by a guarantor or via a third party charge. In order to be eligible, CRM must meet the requirements of the CRR (Articles 195-217) and these differ depending on whether the Standardised or IRB Approach is being used. For example, immovable property is only eligible under the IRB Approach.

10 The risk that a counterparty to a transaction (e.g. a borrower under a loan) could default before the final settlement of the transaction’s cash flows (Article 272(1), CRR).
the basis of a classification in five categories, depending on the underlying credit risk, as well as remaining maturity. This approach is also known as "slotting."\(^{11}\)

Slotting involves the assignment of loans to one of five categories: "strong", "good", "satisfactory", "weak" and "default", to which the following specified risk weights apply:

<table>
<thead>
<tr>
<th>Remaining Maturity</th>
<th>Category 1</th>
<th>Category 2</th>
<th>Category 3</th>
<th>Category 4</th>
<th>Category 5(^{12})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2.5 years</td>
<td>50 %</td>
<td>70 %</td>
<td>115 %</td>
<td>250 %</td>
<td>0 %</td>
</tr>
<tr>
<td>Equal to or more than 2.5 years</td>
<td>70 %</td>
<td>90 %</td>
<td>115 %</td>
<td>250 %</td>
<td>0 %</td>
</tr>
</tbody>
</table>

For the purpose of assigning a specialised lending exposure to a category ranging from one to five, institutions should first verify whether a specialised lending exposure is considered in default, in accordance with the conditions set out in Article 178 of the CRR. When a specialised lending exposure is considered to be in default, institutions are obliged to assign that exposure to category five. When a specialised lending exposure is considered not to be in default, institutions must assign that exposure to category one, two, three or four, by taking into account any pre-determined assessment criteria laid down in secondary legislation.

In assigning a risk category, banks must take into account factors such as the financial strength of the borrower, the political and legal environment; the transaction and/or asset characteristics; the strength of the sponsor and developer, including any public/private partnership income stream; and the security package.

The LMA and other industry bodies have argued that the risk weightings under the slotting regime are far too onerous and exaggerate the level of risk. This, in turn, has disadvantaged certain types of lending (e.g. commercial real estate) compared to others.

On 11 May 2015, the European Banking Authority (EBA) published a consultation paper\(^{13}\) setting out its draft regulatory technical standards on assigning risk weights to specialised lending exposures. These proposals would generally have the effect of increasing the risk weights attributable to individual exposures. However, although the standards have not yet been finalised, institutions are still required to assess and apply the slotting rules.

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\(^{11}\) i.e. there are three approaches for assigning risk weights to specialised lending exposures: the Foundation IRB approach (where the institution does not use own estimations of Loss Given Default (LGD) and conversion factor), the Advanced IRB approach (where own estimations of LGD and conversion factor are used), and supervisory slotting criteria, discussed specifically above.

\(^{12}\) In this category, no capital needs to be held in respect of the loan, but instead the bank will be required to write-off 50% of the outstanding loan amount.

B) Trade finance

Where trade finance takes the form of a bank loan, the relevant lending rules apply. However, where trade finance takes the form of off-balance-sheet exposures or contingent liabilities, credit conversion factors (CCF) are applied. This means that the off-balance-sheet exposure, such as a letter of credit, is converted to an on-balance-sheet equivalent by multiplying it by its CCF. The exposure is then weighted according to the credit risk of the class of counterparty.

Although certain concessions were made by BCBS in respect of trade finance exposures in October 2011, industry bodies still maintain that too much emphasis is placed on counterparty, rather than actual product or performance risk (meaning that capital requirements will be higher for all but the most highly-rated borrowers). In addition, not enough importance has been paid to the risk-mitigating properties of trade finance instruments, such as their self-liquidating nature and short maturities. These mitigating factors are particularly relevant during a period of crisis because risk weights which are determined (for those using the IRB Approach) by factors such as PD and LGD, increase during such periods.

C) CRM

Article 108 of the CRR recognises the use of eligible CRM for risk-weighted exposures under both the Standardised Approach and the IRB Approach. Whilst, from a loan market perspective, there are no material changes to the detail of the CRM eligibility requirements, a key change introduced by Article 194(1) of the CRR is a new obligation for institutions to obtain formal legal opinions in order to satisfy the existing requirement that credit protection must be legally effective and enforceable in all relevant jurisdictions.

Although legal opinions have historically been required in relation to certain derivative and repo transactions where the institution has sought to obtain the benefit of contractual netting to reduce counterparty credit risk, formal legal effectiveness and enforceability opinions have not typically been sought in a credit risk mitigation context. Instead, banks have relied upon other measures, such as review by internal counsel. However, as a result of these amendments (and taking into account the EBA’s guidance contained in its Single Rulebook Q&A), institutions must now obtain formal “independent, written and reasoned” legal opinions in order to benefit from CRM. Although the EBA has indicated that such opinions may be provided by internal counsel, a great deal of confusion in the market remains and no market practice is, as yet, established. In addition, it is also not clear the extent to which generic, as opposed to transaction-specific opinions may be obtained.

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The concessions equated to the following two waivers:

1. a waiver of the one-year floor for the maturity of issued and confirmed letters of credit for banks estimating risk weights under the Advanced version of the IRB Approach (i.e. allowing capital requirements to be matched with the effective product maturity). This is important in a trade finance context given the average short maturities of such instruments – 115 days according to the International Chamber of Commerce Trade Finance Register; and

2. a waiver of the sovereign floor under which no claim on an unrated bank could be allocated a risk weight lower than that of the claims on the country in which it was incorporated (this is particularly important in developing countries, since otherwise the benefits of the lower risk weights for trade-financing transactions (which attract a 20% CCF in the case of both the issuing bank and the confirming bank) could have been extinguished).
That said, the EBA has indicated that where "an institution engages in the same type of transaction, with counterparties located in the same jurisdiction and uses the same credit risk mitigation technique", it can rely on the same opinion.

D) CCR

Article 153(2) of the CRR deals with counterparty credit risk, whereby an increase in risk weightings has been introduced, as a result of which a premium will be imposed on any "exposure" to another financial institution. As a general observation, this is likely to disincentivise interbank lending across the board (or increase funding costs for this market).

More specifically however, it potentially creates unintended consequences for certain types of non-financial borrower - Article 153(2) of the CRR provides that this premium will be imposed very widely – i.e. on both "large financial sector entities" and "unregulated financial entities".

That said, although the definition of "unregulated financial entities" is potentially problematic for certain types of lending transaction (it could capture, for example, lending to SPV structures expressly set up to on-lend monies to a non-financial corporate client) fortunately, largely as a result of the lobbying efforts of the LMA, the legislation no longer captures (non-financial) corporate groups which simply happen to have finance/treasury functions. This is as a result of a concept of

A "large financial sector entity" is defined in Article 142(4) of the CRR (with a minor exception relating to mixed activity insurance holding companies) as any "financial sector entity" which meets the following conditions: (a) "its total assets, calculated on an individual or consolidated basis, are greater than or equal to a EUR 70 billion threshold, using the most recent audited financial statement or consolidated financial statement in order to determine asset size; and (b) it is, or one of its subsidiaries is, subject to prudential regulation in the Union or to the laws of a third country which applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union."

A "financial sector entity" is defined as any of those entities listed in Article 4(27) of the CRR. Article 4(27) includes any of the following:

(a) an institution (i.e. a credit institution or an investment firm);
(b) a financial institution;
(c) an ancillary services undertaking included in the consolidated financial situation of an institution;
(d) an insurance undertaking;
(e) a third country insurance undertaking;
(f) a reinsurance undertaking;
(g) a third country reinsurance undertaking;
(h) an insurance holding company;
(i) a mixed activity holding company;
(j) a mixed activity insurance holding company as defined in point (f) of Article 212(1) of Directive 2009/138/EC;
(k) an undertaking excluded from the scope of Directive 2009/138/EC in accordance Article 4 of that Directive;
(l) a third country undertaking with a main business comparable to any of the entities in points (a) to (k).

An "unregulated financial entity" is defined in Article 142(5) of the CRR as "any other entity that is not a regulated financial sector entity but performs, as its main business, one or more of the activities listed in Annex I to Directive 2013/36/EU or listed in Annex I to Directive 2004/39/EC".
materiality having been introduced into the legislation, ensuring that only those entities carrying on certain financial activities as their "main business" will be caught.

Nevertheless, the legislation continues to create some challenges for loan arrangers and lenders, who will have to analyse which entities actually fall within the relevant definitions (unless the EBA confirms that they are able to rely on some form of borrower self-certification regime, as is the case for non-financial counterparties in danger of breaching the clearing threshold under EMIR). ¹⁷ Without such a regime (or if borrowers are reluctant to self-certify) this will increase the initial due diligence and general management time of loan facilities. In addition, monitoring obligations will grow and there will also be added pressure on the delivery of timely information by the borrower to the syndicate (which will add to the borrower's own administrative burden).

Just some of the questions/issues which a loan arranger/lender will have to consider when analysing which borrowers are "large regulated financial entities", for example, are as follows:

- Will every borrower have to be reclassified on an annual basis following publication of group accounts? If so, if a borrower fluctuates above and below the EUR 70bn threshold from year to year, the current drafting of the CRR would require an adjustment to the capital charge on an annual basis. This process could be difficult to manage, with possible consequences for the predictability of the costs of funding during the life of a loan.

- Will the capital charge apply retrospectively (i.e. be based on the most recently audited accounts which relate to the previous financial year)? This would appear to distort the true classification of a borrower at any given time, since the outcome of the assessment will be historical.

- What will the position be if the borrower's group accounts are not available? How quickly should a lender be required to have access to a borrower's group accounts?

- Where a borrower is a member of a larger non-bank group, it will be necessary for lenders to have access to the consolidated accounts of the bank sub-group in order to classify the borrower. Also, it will be necessary to know whether any specific group member is within the bank consolidation group or not. How is this to be assessed?

- It would appear that the increased capital requirement does not apply to members of groups which are subject to bank consolidated supervision where the group is outside the EU and is not subject to supervision which the EU deems equivalent. This seems to indicate perversely that lending to members of groups which are subject to EU-equivalent supervision will carry a higher risk weighting than lending to members of groups where supervision is not deemed equivalent.

- Where a facility names multiple group entities as borrowers, how should the facility be treated if only some of the named borrowers are in the higher risk category?

¹⁷ The European Market Infrastructure Regulation ((EU) No 648/2012).
If a bank acquires a sub-participation\textsuperscript{18} in a loan to a corporate from a large regulated financial entity, should it treat itself as being exposed to the corporate or to the large regulated financial entity for the purpose of calculating its capital requirement?

In addition to the above, the inclusion of a risk premium for financial institutions is likely to make banks increasingly reluctant to take on a fronting role e.g. under export confirmed letters of credit.\textsuperscript{19} Hence banks' trade finance offerings may also reduce, leading to a decrease in available liquidity for trade finance borrowers.

Overall, when the nature of these requirements is assessed more closely, it becomes clear that not only will lenders be disincentivised from lending to each other (impacting lender liquidity and lenders' funding costs) but that also certain loan products are likely to become more expensive for certain types of borrowers (particularly in the trade finance context). This is on the basis that the products themselves will not only become more costly for lenders to provide, but also more costly to manage and administer. Ultimately, certain providers may decide to stop offering certain loan products altogether.

2. Leverage ratio

\[
\begin{array}{c}
\text{qualifying capital} \\
\hline
\end{array}
\]  \textgreater  \begin{array}{c}
\text{required ratio} \\
\hline
\end{array}
\]

\[\Sigma \text{ gross asset value}\]

In order to restrict a bank's total indebtedness and contain the build-up of leverage in the banking sector, under Basel III, a leverage ratio of 3\% was introduced,\textsuperscript{20} designed to prevent a bank's gross borrowings from being more than 33 times that bank's Tier 1 capital. The Basel III leverage ratio is calculated via the equation set out above – i.e. the bank's Tier 1 capital (the numerator) is divided by the combined sum of its total non-weighted assets and off-balance sheet exposures (the

\textsuperscript{18} Under a LMA-style sub-participation, a "participation agreement" is used to transfer the economic interest in a bank loan from a seller (grantor) to a buyer (participant). Under the participation agreement, the grantor remains the "lender of record" under the loan agreement, passing all loan payments which it receives to the participant. In return, the participant advances to the grantor any sums required to satisfy drawing requests made by the borrower under the loan agreement. Unlike a loan assignment, under a loan participation, the participant does not have any form of contractual relationship with the borrower but rather a participation creates a contractual relationship between the grantor and the participant. It should be noted that a European sub-participation differs from a US sub-participation, since under the latter, the beneficial ownership interest in the underlying loan is transferred from the grantor to the participant. By contrast, under a European sub-participation, no beneficial ownership interest is transferred.

\textsuperscript{19} An export confirmed letter of credit is a contractual commitment whereby a bank commits to pay a seller on behalf of a buyer (located in a foreign jurisdiction) upon presentation by the seller of pre-agreed documentation (e.g. evidence of goods having been shipped). The bank will then send the documentation to the buyer's own bank (normally located in the buyer's jurisdiction) after which the seller's bank is reimbursed by the buyer's bank.

\textsuperscript{20} http://www.bis.org/publ/bcbs270.pdf. In this document, the BCBS confirmed that it would make final adjustments to both the definition and calibration of the Basel III leverage ratio prior to 2017. These adjustments will be based on the BCBS' findings during what it called a "parallel run period". This period will take place between 1 January 2013 and 1 January 2017 and it is during this period that the suggested minimum requirement of 3\% will be tested.
denominator), with the ratio expressed as a percentage. The principle distinction between the capital ratio (see sub-section 1 above) and the leverage ratio is that no risk-weighting is applied to the assets. The BCBS has also stipulated that banks should publish their leverage ratios as part of their Pillar 3 disclosures at the same time as they publish their financial statements (but no less than quarterly) using a standard template developed by the BCBS.

The EU has implemented the Basel III reforms on leverage principally through the CRR.\(^2^1\) Under the CRR, the leverage ratio is calculated in the same way as under Basel III, and, although the precise details are still to be officially finalised, current indicators from both the Commission and the EBA are that the percentage ratio (and the elements used to calculate it) are likely to fall in line with the current Basel III recommendations (which were updated from the original proposals in January 2014).\(^2^2\)

In terms of EU implementation, the leverage ratio will be introduced gradually – regulators began monitoring leverage ratio data in 2013, and institutions were required to publish their leverage ratio (publically) from 1 January 2015.\(^2^3\) That said, the leverage ratio will not apply as a strict rule until 1 January 2018. In this interim period, the CRR requires the Commission to submit a report (alongside a legislative proposal formally introducing the leverage ratio as a binding requirement, if deemed to be appropriate) on the impact and effectiveness of the leverage ratio by 31 December 2016. The introduction of a leverage ratio in the EU will also be dependent on the results of a report to be presented to the Commission by the EBA by 31 October 2016.\(^2^4\)

As a general observation, the introduction of a leverage ratio as an international standard presents certain difficulties, on the basis that a bank's gross borrowings are assessed differently from an accounting perspective from country to country, due to the differing ways in which netting is recognised. Basel III and the CRR have attempted to circumvent this problem by stating that, when calculating leverage ratio exposures, such exposures (excluding derivative and repo exposures) should not be netted. There is, however, some doubt as to the position as regards on-balance-sheet exposures (such as loans collateralised by cash deposits) where the accounting conventions used to prepare the balance sheet permit such netting. Meanwhile, off-balance sheet commitments such as

\(^{21}\) Articles 429 to 430 and Article 451 of the CRR, as amended by a Commission delegated act (Regulation 2015/62).

\(^{22}\) For example, in March 2014, the EBA published a report in which it recommended aligning the CRR definition of the leverage ratio’s exposure measure to the latest Basel III recommendations, in the interest of consistency between the leverage ratio calculation within the EU and the other jurisdictions that implement Basel III.

\(^{23}\) It should be noted that in October 2014, the Commission passed a delegated act (Regulation 2015/62) which made certain amendments to the capital measure and the total exposure measure of the leverage ratio. This was done as a result of the competent authorities uncovering certain shortcomings in the way the measures were previously defined. The EBA had also informed the Commission that there were significant differences in how institutions in different member states understood and interpreted the original rules. Based on the EBA’s analysis, the Commission considered that these differences would result in significant discrepancies in the way the leverage ratio was calculated, which could in turn lead to a situation where the numbers disclosed by different institutions would not be comparable throughout the EU. The Delegated Regulated came into force on 18 January 2015. See http://ec.europa.eu/transparency/regdoc/rep/3/2014/EN/3-2014-7237-EN-F1-1.Pdf for further details.

\(^{24}\) It should be noted that although the leverage ratio does not apply until 2018, some EU authorities have already brought leverage ratios into effect as a binding requirement – for example, the UK Prudential Regulation Authority (PRA) has required UK banks to maintain a 3% leverage ratio (calculated on the basis of the Basel 2014 paper) since 1 July 2014.
loan commitments, guarantees and letters of credit will be included in the calculation at full value, on the basis that they are deemed to constitute a source of potentially significant leverage. However, a CCF will be applied to certain items, which will vary depending on the type of commitment. For example, for undrawn credit facilities, which may be cancelled unconditionally at any time without notice, a 10% CCF should be applied. In addition, under the CRR, for certain "trade finance off-balance sheet items" and "other off-balance sheet items" a CCF of either 20% or 50% should be applied, depending on whether such items are deemed to be "medium/low" or "medium" risk.

What does this mean for the syndicated loan market?

Whilst the introduction of a leverage ratio may bring about a certain amount of deleveraging to ensure compliance with the 3% ratio, more worrying for the loan market specifically is the drafting of Article 429(5)(c) of the CRR, which imposes an absolute prohibition on the ability of lenders to set off a loan against deposits for the purpose of calculating their leverage ratio.

Firstly, this is something which is likely to be inconsistent with IFRS rules – under certain conditions, IFRS allows for de-recognition of netting of certain loan assets linked to designated pre-funding or cash backing. This is often used in trade finance structures through the offering of bonds and guarantees. Secondly, Article 429(5)(c) will also stifle the use of cash collateralised fronting mechanics for letters of credit (already under threat from aforementioned capital requirements). These proposals could therefore lead to a reduction in the number of institutions willing to offer borrowers access to trade finance products.

Finally, in addition to threatening trade finance structures, there are fears that the rules regarding leverage could threaten the pricing benefits borrowers are able to obtain in situations where lenders can combine borrowers’ debit and credit accounts. Combining these accounts is based on banks’ legal rights of set-off, which enable them to view liabilities on an overall net basis. Thus, although the accounts concerned record credit and debit balances, there is legally only a single amount payable. This is a long-established, legally accepted method which results in a service that enables borrower groups to manage their financings more efficiently. Therefore, the removal of this right would ultimately have a detrimental impact for borrowers who rely on the combining of accounts under overdraft facilities to obtain flexible borrowing across the group against lower costs.

25 The CCF is intended to reflect the likelihood of an off-balance sheet position becoming an on-balance sheet item – i.e. off-balance-sheet exposures are converted to their on-balance-sheet equivalents by multiplying them by CCFs.

26 See Article 429(10) and Annex I of the CRR for further details. It is worth noting that sub-paragraphs (2) and (3) represent a concession under the CRR which was not provided for by the original Basel III recommendations. This followed criticism by the trade finance industry of the original Basel III formula, which stipulated that a bank’s off-balance sheet items, including those associated with trade finance products, would largely have a CCF of 100% (the only exception being unconditionally cancellable commitments). In the industry’s view, this gave insufficient credit to the low risk nature of trade finance products and the fact that they are rarely, in practice, converted into on-balance sheet exposures. In January 2014, the Basel Committee revised its approach in line with that of the CRR (see page 18 of http://www.bis.org/publ/bcbs270.pdf and Appendix 5 of http://www.bis.org/publ/cgfs50.pdf for further details).
3. **Liquidity ratios**

a. **Liquidity Coverage Ratio (LCR)**

High quality liquid assets\(^{27}\) \(\geq\) Total net cash outflows

The objective of the LCR, which, under the CRR, will be phased in gradually (starting at 60% in 2015 and reaching 100% on 1 January 2018)\(^{28}\) after an initial observation period, is to ensure that an institution is able to maintain an adequate level of unencumbered, high-quality, liquid assets that can be converted into cash (at little or no loss to value) to meet its liquidity needs for a 30-day time horizon under a severe liquidity stress scenario. Under the LCR, the institution must therefore hold a stock of high quality liquid assets which is at least equal to total net cash outflows.

The formula for the basis of the calculation is as follows:

\[
\text{HIGH QUALITY LIQUID ASSETS} \geq \text{TOTAL NET CASH OUTFLOWS} \quad \text{("TNCO")}
\]

\[
\text{TNCO} = \begin{cases} 
\text{TOTAL EXPECTED CASH OUTFLOWS} \quad \text{("TECO")} - \text{TOTAL EXPECTED CASH INFLOWS} \quad \text{("TECI")} \\
\end{cases}
\]

\[
\text{TECO} = \begin{cases} 
\text{OUTSTANDING BALANCE OF CERTAIN LIABILITIES & OFF BALANCE SHEET COMMITMENTS} \times \text{EXPECTED RATE OF DRAWDOWN} \quad \text{OR}
\end{cases}
\]

\[
\text{TECI} = \begin{cases} 
\text{OUTSTANDING BALANCE OF CERTAIN CONTRACTUAL RECEIVABLES} \times \text{EXPECTED RATE OF AGGREGATE CAP OF FLOW-IN (UP TO)}
\end{cases}
\]

\(^{27}\) High Quality Liquid Assets are assets that can be sold on private markets with no or little loss of value, even in stressed conditions. HQLA are composed of three tiers: Level 1, Level 2A and Level 2B. Level 1 HQLA are the most liquid assets. They may be used without limit in the liquidity buffer and are not subject to a discount (or haircut) to their market value. They include: cash, deposits at the central bank, government or government guaranteed bonds, and covered bonds that meet certain specific conditions. However, the last are subject to a 70% cap in the liquidity buffer and a 7% haircut. Level 2A HQLA can be used up to maximum of 40% in the liquidity buffer and are subject to a minimum 15% haircut. They include third country government bonds and bonds issued by public entities with a 20% risk weight and EU covered bonds, non-EU covered bonds and corporate bonds (subject to minimum ratings requirements). Finally, Level 2B HQLA can be used up to a maximum of 15% in the liquidity buffer and are subject to a minimum haircut varying between 25 and 50%. They include: high quality securitisations for RMBS, auto, SME and consumer loans; corporate bonds (subject to a minimum rating); shares that are part of a major stock index; and other high quality covered bonds.

It should be noted that under the Commission Delegated Regulation (2015/61), the Commission extended the range of securitisation instruments eligible as level 2B HQLA for credit institutions' liquidity buffers to include auto, SME and consumer loans in addition to RMBS (which was the only type of securitisation product eligible under the original legislation). However, to qualify for these purposes, ABS instruments will have to meet certain "high quality" requirements. Such requirements are identical to those that will apply under the Solvency II Delegated Act (see section on Solvency II for further details) but in addition, they will be subject to certain additional requirements specific to liquidity, such as a minimum issue size (EUR 100 million) or a maximum weighted average life (no more than five years). For further discussion on the treatment of securitisation in the context of CLOs, please see Section 3.

\(^{28}\) This is the approach adopted under the CRR (Article 460, paragraph 2). Basel III had recommended a similar approach, but did not require 100% until 1 January 2019.
75% OF TECO)

Essentially, the basic requirement is that the liquidity pool containing the high quality liquid assets must be capable of meeting total net cash outflows over a 30-day period. Net outflows are based on expected cash outflows (e.g. withdrawal of deposits/loan drawdowns) having taken the benefit of any expected contractual cash inflows into account (e.g. loan interest payments from borrowers). However, certain assumptions will be applied by the regulator when assessing what the expected cash outflows/inflows actually are, and must be multiplied by a pre-specified "run-off or drawdown rate" (in the case of outflows) or a pre-specified "inflow rate" (in the case of inflows).

Article 412 of the CRR sets out the general LCR framework but does not specify a detailed ratio requirement. The binding requirement is, however, set out in a Commission Delegated Regulation (2015/61)(LCR Delegated Regulation)\(^\text{29}\), which was published in the Official Journal in January 2015. The LCR Delegated Regulation sets out rules governing which assets will qualify as high quality liquid assets (HQLA) and how cash outflows and inflows should be calculated. Until the LCR becomes binding, member states are able to maintain or introduce minimum liquidity requirements as they see fit. It should also be noted that although both banks and investment firms are subject to the general liquidity requirement under Article 412(1), only banks are directly subject to the detailed LCR set by the LCR Delegated Regulation.\(^\text{30}\)

The precise outflows/inflows to be applied that are applicable to loans are also set out in the LCR Delegated Regulation (Article 31) and are the same as those recommended under Basel III. So, in the case of outflows:

- **committed credit and liquidity**\(^\text{31}\) facilities that qualify for the retail deposit exposure class will be subject to a drawdown rate of 5%;

- **committed credit** facilities to clients that are not financial customers\(^\text{32}\) (to include non-financial corporates, sovereigns, central banks, multilateral development banks and public sector entities)

\(^{29}\) http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32015R0061

\(^{30}\) The application of the LCR to investment firms is not required by Basel and still has to be assessed within the EU. Under Article 508(2) CRR, the EBA has to prepare a report on the application of the LCR to investment firms by the end of 2015 and then the Commission has to report on the issue to the Parliament and the Council, followed by a legislative proposal if appropriate. In the meantime, investment firms will remain subject to the national law of the Member States.

\(^{31}\) Under the LCR Delegated Regulation, a liquidity facility is described as "any committed, undrawn back-up facility that would be utilised to refinance the debt obligations of a customer in situations where such a customer is unable to rollover that debt in financial markets". The LCR Delegated Regulation goes on to state that "its amount shall be calculated as the amount of the debt issued by the customer currently outstanding and maturing within 30 calendar days that is backstopped by the facility. The portion of the liquidity facility that is backing a debt that does not mature within 30 calendar days shall be excluded from the scope of the definition of the facility. Any additional capacity of the facility shall be treated as a committed credit facility with the associated drawdown rate as specified in this Article. General working capital facilities for corporate entities will not be classified as liquidity facilities, but as credit facilities."

\(^{32}\) Under the Delegated Regulation, a “financial customer” is a customer that performs one of the activities set out in Annex 1 of the CRD as its main business, or is one of the following:

(i) a credit institution;

(ii) an investment firm;
will be subject to a drawdown rate of 10%, assuming that they have not been provided for the purpose of replacing funding of the client in situations where the client is unable to obtain funding requirements in the financial markets;

- committed **liquidity** facilities to clients that are not financial customers will be subject to a drawdown rate of 30%;

- committed **credit and liquidity** facilities extended to credit institutions will be subject to a drawdown rate of 40%;

- committed **credit** facilities extended to other regulated financial institutions, including insurance undertakings and investment firms, CIUs or non-open ended investment schemes, will be subject to a drawdown rate of 40%; and

- committed **liquidity** facilities extended to other regulated financial institutions, including insurance undertakings and investment firms, CIUs or non-open ended investment schemes will be subject to a drawdown rate of 100%.

It should be noted that outflows relating to securitisation special purpose vehicles (SSPE) are dealt with separately under Article 31. For example, the undrawn committed amount of a liquidity facility that has been provided to an SSPE for the purpose of enabling such an SSPE to purchase assets, other than securities from clients that are not financial customers, shall be subject to a draw down rate of 10%, to the extent that it exceeds the amount of assets currently purchased from clients and where the maximum amount that can be drawn down is contractually limited to the amount of assets currently purchased. However, other types of liquidity facilities granted to SSPEs are subject to a drawdown rate of 100%.

The practical effect of the above is a liquidity contribution requirement – for example, if a bank were to grant a £100m credit facility to a financial institution (which was not a bank subject to prudential supervision) it would have to immediately allocate 40% of the value of that commitment in the form of liquid assets within its liquid asset pool.

**What does this mean for the syndicated loan market?**

Clearly, the LCR requirements will have a significant impact on bank lenders in respect of committed undrawn facilities, since these will be required to be backed with liquid assets. Under historic rules, banks were only required to hold sufficient assets to fund likely outflows as assessed by the bank

(iii) a financial institution;

(iv) a securitisation special purpose vehicle (SSPE);

(v) a collective investment undertaking (CIU);

(vi) a non-open ended investment scheme;

(vii) an insurance undertaking;

(viii) a reinsurance undertaking;

(ix) a financial holding company or mixed financial holding company.
itself. However, under the new proposals, the regulator has already pre-determined the relevant assumptions based on a scenario of extreme financial stress, requiring institutions to set aside liquid assets accordingly. In addition, given that liquid assets tend to be low-yielding, the maintenance of the asset pool itself is likely to result in considerable additional cost.

However, the LCR is also likely to have certain repercussions for the loan market. Firstly, loans themselves are not eligible for inclusion within the liquid asset pool, regardless of the underlying borrower. However, corporate bonds which satisfy certain requirements may be included, albeit subject to haircuts. This could result in corporate bonds becoming a more attractive income source for banks than corporate loans. Secondly, the specific requirements relating to liquidity facilities mean that institutions will be particularly disincentivised from offering such facilities to other financial institutions (on an unsecured basis – secured funding backed by collateral is assessed differently). This is likely to impact the way in which financial institutions fund themselves (on the basis that they will have reduced access to funds from other financial institutions). In addition to this, loan facilities may well be subject to increased due diligence and general administrative burdens, as banks are forced to analyse the treatment of individual facilities/structures/borrowers for the purposes of their liquidity requirements.

Some of the key issues which need to be considered from a loan market perspective are as follows:

- Whilst certain liquidity facilities to SSPEs are subject to lower liquidity requirements, this does not apply across the board. For example, lower requirements would not be extended to liquidity lines offered to CLOs unless their investment powers were expressly limited to buying loans to non-financial customers.

- In many ways, it is difficult to see how the 100% liquidity requirement for financial institutions equates to a realistic and valid assessment of the risk associated with different credit lines. For example, in the non-bank financial institution (NBFI) space, subscription lines may be offered (e.g. to infrastructure funds for capital calls) which are not liquidity lines at all. In any event, setting aside 100% of the principal, regardless of loan purpose or borrower type or creditworthiness, is not necessarily a realistic assessment of how such facilities behave during a period of actual stress.

- The drafting for liquidity facilities makes no distinction between the credit ratings of borrowers – i.e. a liquidity facility offered to a highly rated borrower will generate the same liquidity requirement as one which is lower rated. This ignores the fact that a significant determinant of the likely level of drawings under a liquidity facility is usually the credit rating.

- From a practical perspective, the drafting is unclear as to what steps a lender would need to take in order to convince a regulator that a particular facility was advanced for one purpose or the other. Many credit facilities are made available to borrowers for “general working capital purposes”. Banks do not tend to monitor how the drawn loan proceeds under such facilities are used. To avoid classification of such general working capital facilities as liquidity facilities, it may be necessary for lenders to monitor the use of funds drawn down under such facilities or be more specific in the drafting of the purpose clause.
• The LCR provisions of CRD IV use the definition "financial customer" rather than specifically referring to financial institutions (which is the wording used under Basel III). The definition of "financial customer", provided at Article 31 of the Delegated Regulation, effectively catches any customer that performs one or more of the activities listed in Annex I of the CRD as its main business. Consequently, the same definitional issues arise here as were raised earlier on when discussing risk weightings and unregulated financial entities (e.g. lending to SPV structures expressly set up to on-lend monies to a non-financial customer).

• Finally, in a trade finance context, concerns have been expressed about the calculation of cash outflows and inflows and their impact on trade finance-related contingent facilities (such as letters of credit). Although the position has improved since the original Basel III proposals (under which outflows were left open to national discretion, raising fears that these would be as high as 100%, as is the case for other contingent liabilities, whilst inflow rates were assumed to be equal to 50% of payments contractually due within a 30-day horizon from corporate clients, which the industry considered too low), the specification of the LCR under Basel III (published in January 2013) states that a low outflow rate of between 0–5% is expected to apply to contingent trade finance exposures. That said, BCBS has not altered its stance in relation to the calculation of inflows. Fortunately, the European position is more favourable. Under Article 425 of the CRR, monies due from trade financing transactions with a residual maturity of up to 30 days will be taken into account in full as inflows. Whilst this is a positive step, it is unclear whether other jurisdictions outside Europe will follow suit, or keep to the current Basel III recommendations.

When analysed collectively, in addition to favouring the use of bonds over loans, discouraging the offering of certain facility lines, disincentivising the use of certain loan structures and trade finance products and increasing loan due diligence across the board, many of the requirements imposed by the LCR may also lead to changes being made to the documentation of loan facilities in the future. For example: pricing step-up mechanics; stricter governance for borrowers, requiring them to inform lenders of changes to obligors and their activities generally; tailor-made swingline concepts in line with actual back-up needs (and resulting changes to loan purpose clauses); and information undertakings on the part of borrowers to inform lenders of their drawing requirements within the next 30 days could all be introduced. None of these are likely to be welcomed by the borrower community, particularly those who have entered into loans specifically with the aim of obtaining flexible financing.

b. Net Stable Funding Ratio (NSFR)

\[
\frac{\text{Available amount of stable funding}^{33}}{\text{Derived from CRD IV}} \qquad \Rightarrow \qquad 100\% \\
\frac{\text{Required amount of stable funding}^{34}}{\text{Current maturity}} \qquad \Rightarrow \qquad 100\%
\]

\footnote{33}{i.e. specified reliable sources of funds x specific available funding (ASF) factor for each asset type.}
Under the NSFR, institutions must structure their funding so that the amount of long-term funding is at least equal to their illiquid assets. The amount of funding required will depend on the type of asset held, off-balance sheet contingent exposures incurred and/or activities pursued by the relevant institution. In basic terms, by imposing this ratio, regulators are seeking to limit the extent to which institutions are able to rely on short-term debt (i.e. debt with a maturity of less than 12 months) as a proportion of their total funding.

**What does this mean for the syndicated loan market?**

Under the NSFR, funding from financial institutions may not be used as a source of stable funding, regardless of the form it takes. The effect of this is to encourage institutions to fund exposures from other sources, such as capital, long-term debt or non-financial sector deposits. The "stable" funding generated may then be used to fund those assets which are not deemed capable of being liquidated within a 12 month period. However, the assessment of which assets constitute illiquid assets has also been pre-determined. The effect of this is that, for example, under Basel III, 50% of loan amounts to non-bank financial institutions and non-financial corporate clients with a residual maturity of less than one year must be financed from stable funding, whilst this increases to either 65% or 85%35 for loans to those same entities if the residual maturity exceeds one year. Loans to banks, meanwhile, must be funded 100% by stable funding unless the maturity of that loan is less than one year (in which case the stable funding requirement is either zero or 50%, depending on whether the loan is for more or less than six months). By comparison, bonds are treated more favourably – for example, only 15% of corporate bond amounts rated AA- or higher must be supported by stable funding.

When analysing the above, it becomes clear that institutions will need to allocate a large proportion of their stable funding to support loan market activities and may, therefore, look to reduce their exposure to this product generally. This is perhaps more likely given that corporate bonds are, in most cases, treated more favourably than corporate loans.

It should be noted, however, that the NSFR is not directly covered by CRD IV, which rather contains a general requirement to ensure that long term obligations are adequately met with a diversity of stable funding instruments under both normal and stressed conditions.36 The intention is that the Commission will submit a legislative proposal by 31 December 2016 (following a lengthy observation period conducted by the EBA and a report on the merits of introducing the NSFR to be submitted by the end of 2015 – Article 510 CRR) and legislation will not be introduced until 1 January 2018. As a result of continued criticism of the ratio and its consequences, it may be that the proposals are reassessed at a later date.

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34 i.e. the sum of the value of assets held and funded x specific required funding (RSF) factor for each asset type + off-balance sheet liabilities x RSF factor.

35 Loans that would qualify for a 35% or lower risk weight under the Basel II Standardised Approach for credit risk will attract a RSF factor of 65%, whilst loans that would not, will attract a RSF factor of 85%.

36 Article 413 CRR
B. Insurers and reinsurers – Solvency II

What is Solvency II?

Solvency II takes the form of an EU Directive (2009/138/EC, as amended by the Omnibus II Directive (2014/51/EU)) and seeks, amongst other things, to establish new risk-based capital requirements for all but the smallest insurers and reinsurers.

Under Solvency II, affected firms must hold sufficient capital reserves to meet any expected future insurance or reinsurance contractual liabilities (i.e. liabilities to policyholders and beneficiaries) otherwise known as the "technical provisions". Technical provisions are calculated on a best estimate basis of future cash flow obligations, discounted to present day value, plus an additional risk margin to reflect the cost of capital.

In addition to holding capital to cover technical provisions, firms must also hold enough capital to comply with both a "minimum capital requirement" (MCR) and a "solvency capital requirement" (SCR) (MCR and SCR, taken together, being known as the "own funds" requirement).

The MCR equates to an absolute minimum level of capital that a firm is required to maintain – anything below that level and it is deemed "insolvent" for regulatory purposes. The SCR, meanwhile, is a higher requirement, having taken into account any risk mitigation techniques adopted by the firm (i.e. measures taken to transfer risk to a third party) and is intended to reflect a level of funds which would enable the firm to absorb significant losses in a range of scenarios and continue to meet its obligations to policy holders and beneficiaries. Whilst a breach of the MCR or SCR will require supervisory action to restore the financial position of the firm as soon as possible, a breach of the MCR will lead to more serious consequences if not remedied within a certain period (such as potential withdrawal of authorisation to write new business).

From a capital perspective, Solvency II also sets out the extent to which different types of assets may be used to cover a firm's own funds requirements, with a distinction being made between balance sheet ("basic own funds") and off-balance sheet ("ancillary own funds") resources (with use of the latter being subject to supervisory approval). Assets are then divided into three tiers of eligible capital, with limits being imposed on the extent to which lower tiers are able to satisfy the MCR and SCR.

A basic summary of the Solvency II requirements is set out on the following page:

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37 For a consolidated version of Solvency II, please go to this link: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:02009L0138-20140523&from=EN
To calculate a firm's overall capital requirement, the balance sheet is divided into various categories or “risk modules”. These categories are intended to reflect all the risks to which the balance sheet is exposed, such as non-life, life and health insurance, as well as other balance sheet risks such as market and counterparty risk.

Each of the risk modules requires the firm to undertake a calculation, resulting in a capital requirement for that module. The resulting figures are then input into an overall calculation to ascertain the overall SCR (i.e. the capital requirement for each asset is aggregated via the use of correlation matrices to that of all other assets). Whilst some (larger) firms will calculate these risks using their own internal models approved by the regulator, others will use the standard formula prescribed under Solvency II (or a combination of the two).

Looking to the standard formula, of the various risk modules that make up the SCR, the “market risk module” calculates capital requirements covering the market risk\(^{38}\) of financial assets. This equates to the value-at-risk\(^ {39}\) in a stressed market for each relevant asset. The market risk module has been

\(^{38}\) Market risk arises from the level or volatility of market prices of financial instruments. In the market risk module, exposure to market risk is measured by the impact of movements in the level of various financial variables, such as equity prices, interest rates, yield spreads, property prices, and exchange rates.

\(^{39}\) Value at risk is a commonly used risk measure which estimates the risk of loss in relation to a specific asset or portfolio of assets.

It is worth noting that different risk measures are applied in arriving at the capital requirements applied under Solvency II compared to the CRR. Under Solvency II, capital requirements are determined on the basis of a 99.5% value-at-risk.
further categorised so that assets are split into equities, interest rates, property, currency, concentration or spread risk (known as sub-modules). Under Solvency II, there is no longer any limit on the proportion of the insurer’s balance sheet which can be invested in certain asset types although a prudent investor principle is applied, with the result that assets must be properly diversified so as to avoid excessive reliance on any particular asset.

Loans (as well as bonds and securitisations), other than certain residential mortgage loans, are all assessed as part of the “spread risk” sub-module, by which the market value of each asset is multiplied by pre-determined “stress factors”, having taken into account the type of asset, its "modified duration" and its rating. For floating rate loans, the duration is equivalent to the modified measure over one year i.e. enough capital must be held to cover any market-consistent losses that may occur over the next year with a confidence level of 99.5%, resulting from changes in the market value of assets held by insurers. By contrast, under the CRR, risk weightings are allocated to assets held by bank investors on the banking book (i.e. assets that are not regularly traded and which are expected to be held to maturity) which reflect the credit risk of exposure to those assets. The different risk measures applied mean that capital requirements for the same asset held by both bank and insurer investors will not be the same.
duration of a fixed interest rate loan of the same maturity and with interest payments equal to the forward interest rate.

By way of example, the following table illustrates the stress factors applicable to both a loan and bond portfolio.\(^{40}\)

<table>
<thead>
<tr>
<th>Credit rating</th>
<th>Modified Duration in years (dur(^i))</th>
<th>Stress Factor</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B or less</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>a(^i) (%)</td>
<td>b(^i) (%)</td>
<td>a(^i) (%)</td>
<td>b(^i) (%)</td>
<td>a(^i) (%)</td>
<td>b(^i) (%)</td>
<td>a(^i) (%)</td>
</tr>
<tr>
<td>Up to 5</td>
<td>b(^i) x dur(^i)</td>
<td>-</td>
<td>0.9</td>
<td>-</td>
<td>1.1</td>
<td>-</td>
<td>1.4</td>
<td>-</td>
</tr>
<tr>
<td>More than 5 and up to 10</td>
<td>a(^i), b(^i) x(dur(^i)⁻0.5)</td>
<td>4.5</td>
<td>0.5</td>
<td>5.5</td>
<td>0.6</td>
<td>7.0</td>
<td>0.7</td>
<td>12.5</td>
</tr>
<tr>
<td>More than 10 and up to 15</td>
<td>a(^i),b(^i) x(dur(^i)⁻10)</td>
<td>7.0</td>
<td>0.5</td>
<td>8.4</td>
<td>0.5</td>
<td>10.5</td>
<td>0.5</td>
<td>20.0</td>
</tr>
<tr>
<td>More than 15 and up to 20</td>
<td>a(^i),b(^i) x(dur(^i)⁻15)</td>
<td>9.5</td>
<td>0.5</td>
<td>10.9</td>
<td>0.5</td>
<td>13.0</td>
<td>0.5</td>
<td>25.0</td>
</tr>
<tr>
<td>More than 20</td>
<td>min [a(^i),b(^i) x(dur(^i)⁻20) :1]</td>
<td>12.0</td>
<td>0.5</td>
<td>13.4</td>
<td>0.5</td>
<td>15.5</td>
<td>0.5</td>
<td>30.0</td>
</tr>
</tbody>
</table>

So, for example, the stress factor for a loan or bond which is rated BBB and which has a modified duration of seven years will be:

\[
12.5\% + (1.5\% \times (7 - 5)) = 15.5\%
\]

Consequently, for a loan with a market value of £50mn, the base capital requirement for that loan (i.e. before any other factors are taken into account) will be £7.75mn.

Different calculations apply to unrated assets, but for such assets, collateral may be taken into account. As a rough guide, if the risk adjusted value of the collateral taken is above or equal to the market value of the loan, the stress factor is halved. So, by way of example:

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\(^{40}\) See Section 5 of the Delegated Regulation.
Solvency II also introduces greater flexibility with regards to the assets that insurers are able to invest in to cover their technical provisions (previously the legislation set out a list of specified assets and stipulated exposure and counterparty limits). Instead a "prudent investor principle" will be applied to all investment decisions.

Finally, Solvency II also sets out the basis of valuation for both liabilities and assets.

**When will it be implemented?**

The Solvency II Directive was adopted on 22 April 2009 and member states were originally required to implement the requirements by 31 October 2012. However, these dates were put back by an amending Directive (2013/58/EU) (Amending Directive) which delayed the transposition and implementation dates to 31 March 2015 and 1 January 2016 respectively. The Amending Directive was necessary due to the fact that the new Omnibus II Directive (Omnibus II), which amended the Solvency II Directive (amongst other things, to reflect the revised EU financial services supervisory framework and to bring it into line with the legislative process put in place by the Lisbon Treaty) had been delayed.

On 10 October 2014, the Commission adopted a Delegated Regulation (2015/35) containing implementing rules for Solvency II. Following approval of the European Parliament and Council, this was published in the OJ on 17 January 2015 and entered into force the following day. As the Delegated Regulation takes the form of a regulation, it applies directly to national supervisors and firms without requiring transposition into the national law of member states.

The Delegated Regulation provides more detailed rules on, amongst other things: the valuation of assets and liabilities, including technical provisions, in particular the so-called “long-term guarantee measures”; how to calculate the level of capital for asset classes an insurer may invest in; the eligibility of insurers’ own fund items to cover capital requirements; how insurance companies should be managed and governed; equivalence assessments of third-country solvency regimes; the internal model framework; and rules relating to insurance groups.

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[41] These were measures introduced by the Omnibus II Directive to smooth out artificial volatility and ensure that insurers could continue to provide long-term protection at an affordable price. The measures aim to mitigate artificial volatility by partially reflecting movements in asset prices in the market-consistent valuation of the liabilities, thereby reducing artificial balance sheet volatility.
What does this mean for the syndicated loan market?

Solvency II has clear implications for the investment strategies of insurers and reinsurers, since any investments will be used, to the extent possible, to support their technical provisions and capital requirements.

Under earlier legislation, insurers were only permitted to count assets against their capital requirements that were on a pre-determined list of "admissible assets". Under the new Solvency II requirements, however, the rules are not so prescriptive, with assets being assessed in accordance with broader principles relating to general prudence, security and overall liquidity. Essentially, once implemented, insurers will be given greater freedom to invest provided that certain criteria are met (e.g. relating to the quality, maturity profile and diversification of the assets) and any investment risks are capable of being monitored. In addition, (as previously discussed) insurers will also have to assess various categories of risk in relation to the specific asset held and hold additional capital to cover such risks. For example, the capital charge for equities is high to reflect the perceived riskiness of the asset class, the capital charge for an exposure to debt varies depending on the duration of the debt and the rating of the counterparty (see previous section for further details).

In practical terms therefore, debt with long maturity profiles, many structured finance products, real estate and investment in certain types of private equity and hedge funds all carry higher capital charges, at least when compared to government securities and short-dated debt. Higher-rated instruments will also be given better treatment than low (less than single A) or unrated instruments (especially if security is not taken). As a result of the above, interest in loan investment may well increase, particularly for those loans which are to higher-rated borrowers, are fully secured and have shorter tenors.

Although investment in long-term debt is, as a general rule, likely to decrease (due to the fact that the capital charge which applies to loans is calculated by a function of the rating of the borrower (the higher the rating, the lower the rating factor applied) multiplied by the term of the loan), on 27 February 2015, EIOPA published a call for advice from the Commission, in which EIOPA was requested to provide technical advice on the need to amend the Delegated Regulation to facilitate insurers' investment in infrastructure. The Commission emphasised that whilst Solvency II currently sets out calibrations for capital charges on equity and debt instruments, these did not take into account the specific nature and features of infrastructure. Consequently, EIOPA has been asked to give advice on potential alterations to the Delegated Regulation. In particular, it has been asked to develop specific proposals to cater for infrastructure risk.

In response to the above, EIOPA published a discussion paper on infrastructure investment by insurers on 27 March 2015, followed by a consultation paper on 2 July 2015. The deadline for comments on the consultation paper was 9 August 2015, with EIOPA now to provide final technical advice to the Commission by the end of September 2015.

As a result of the above, whilst there was initially a concern that the project finance market could be detrimentally impacted by Solvency II, it is likely that the position may improve for some types of

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42 It should be noted that some funds attract lower risk charges.

infrastructure investment. However, other types of longer term investment will still be penalised over the shorter term (although there is potential for firms to reduce capital charges through "matching" provisions, enabling them to match assets and liabilities). In addition, collateral arrangements can reduce the amount of capital the insurer is required to hold in relation to a loan but the collateral itself does also need to be stressed to determine the extent to which it can be taken into account. Finally, it should be remembered that firms may also apply their own internal risk model rather than the standardised one and thereby bring about a lower capital charge if their assessments indicate a reduced risk. However, not all institutions may wish to follow this approach – in any event, internal risk models first require regulatory approval.

Solvency II will also impact the syndicated loan market via insurer investment in CLOs, which are considered to fall within the definition of a securitisation. The definition of a securitisation (which is the same under Solvency II as under the CRR) includes any transaction in which the credit risk of an exposure, or pool of exposures, is tranchled, and losses on the pool are distributed in accordance with any subordination of those tranches. CLOs are categorised as securitisations on the basis that they issue their bonds in tranches.

Solvency II distinguishes between "Type 1" and "Type 2" securitisations, with the former considered to be of higher quality, and given lower stress factors as a result (under the standardised model). "Type 2" securitisations, meanwhile, have significantly higher stress factors. The definition of a Type 1 securitisation is based on a report by EIOPA and is aligned with the LCR Delegated Regulation pertaining to the CRR (see section above on the LCR and the CRR for further details) – i.e. they include asset classes such as RMBS, loans to SMEs, auto-loans and consumer credit. They do not include managed CLOs or other types of corporate loan securitisation. Evidencing whether a particular securitisation is a Type 1 securitisation or not is therefore of significant importance to insurers under Solvency II. For example, whilst a Type 1 securitisation of an AAA rated loan with a modified duration of three years will have a stress factor of 6.3%, a Type 2 securitisation with the same rating and duration will attract a stress factor of 37.5%.

Other special rules also apply to investments in securitised loan portfolios under Solvency II. For example, in addition to specific requirements regarding risk monitoring and assessment of the underlying assets, the firm may also only invest in these assets if the originator, sponsor or original lender expressly undertakes to retain a net economic interest of not less than 5%. Given that the requirements impose higher capital charges on these types of assets than equivalently rated bonds (notwithstanding the lesser charges are designated Type 1) it is likely that insurers and reinsurers may be less inclined to invest in structured loan products once the Solvency II measures are in place.

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44 This requirement is part of a wider regulatory regime with regards to risk retention requirements imposed on certain parties to a securitisation. Risk retention requirements and their impact on the loan market are discussed in more detail in Section three.
Section 2

BANK STRUCTURAL REFORM AND RING-FENCING REQUIREMENTS

A. Banking Reform Act

The Financial Services (Banking Reform) Act 2013 (the Banking Reform Act) published by the UK Government on 4 February 2013, amends the Financial Services and Markets Act 2000 and implements (amongst other things) the recommendations made by both the Independent Commission on Banking (ICB) chaired by Sir John Vickers (the Vicker’s Report) and the Parliamentary Commission on Banking Standards (PCBS) established in July 2012. The legislative changes fall under three main headings: 1) ring-fencing banking services; 2) depositor preference; and 3) increasing banks' primary loss-absorbency capacity (PLAC) requirements.

When will it be implemented?

The Banking Reform Act received Royal Assent on 18 December 2013. Much of the detail of the reforms is set out in secondary legislation, which has primarily been produced by HM Treasury using the powers granted to them under the Banking Reform Act. Although all of the relevant legislation has now been passed, banks will not be required to implement the ring-fence until 2019.

Who will it impact?

Whilst the changes relating to bank loss-absorbing and depositor preference are likely to have serious repercussions for the banking sector generally, this guide will focus exclusively on the ring-fencing requirements, since these are likely to have the biggest impact on the syndicated loan market.

The ring-fencing requirements apply to any UK institution (excluding non-bank institutions or building societies) which is required to be ring-fenced by virtue of its exceeding the threshold for holding "core deposits" (set at £25bn (the De Minimis Threshold)) even if headquartered outside the EEA. The legislation also creates a fixed four year "grace period" from ring-fencing for banks which breach the threshold abruptly, due to a merger or acquisition. For groups with multiple deposit takers the £25bn threshold applies to the sum of core deposits. This prevents evasion of the ring fence by spreading deposits below the threshold across multiple entities.

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45 The PCBS, consisting of members of both the House of Commons and the House of Lords, was originally established to conduct an inquiry into professional standards in the banking sector following allegations surrounding manipulation of LIBOR. It was decided that the PCBS should also scrutinise the proposed Banking Reform Act and, as a result, the PCBS published its written evidence on 8 November 2012.

46 A UK institution is a body corporate incorporated in the UK. Currently only banks are affected but the broad "institution" definition is a deliberate, future proofing device that means other types of entities could be brought into scope if the scope of "core activities" is extended beyond deposit taking. Separate rules will be brought in for building societies via amendments to the Building Societies Act 1986.

How will it impact the syndicated loan market?

Under the ring-fencing requirements, "core activities" (described as "mandated activities" in the Vickers Report) may only be provided by ring-fenced banks. Core activities currently only equate to the acceptance of deposits, although accepting a deposit is not a core activity unless the deposit is a "core deposit" i.e. it is held with a UK deposit-taker in an EEA account. That said, the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (the Ring-fenced Bodies and Core Activities Order), which came into force on 1 January 2015, states that the deposits of certain types of account holder will fall outside the definition (i.e. they will not be required to be ring-fenced). Such account holders include:

- relevant financial institutions;
- qualifying organisations;
- qualifying group members; or
- eligible individuals.\(^\text{48}\)

In addition to the above, the requirements also provide for the concept of "core services". These are services whose interruption could adversely affect the stability of the UK financial system or a significant part of it. The objective of the ring-fence is to protect the provision of core services generally, not just deposit taking activities. The Banking Reform Act sets out the following as core services:

- facilities for the acceptance of deposits or other payments, into an account which is provided in the course of carrying on the core activity of accepting deposits;
- facilities for withdrawing money or making payments from such an account; and
- overdraft facilities in connection with such an account.

The Government has stated that other services may be designated as core services in the future.

In addition, ring-fenced banks may also provide other services, but will be specifically prohibited from carrying out "excluded activities" (described as "prohibited activities" in the Vickers Report). The Banking Reform Act specifies that dealing in investments as principal is an excluded activity. The Banking Reform Act also gives HM Treasury the power to designate other activities as excluded activities, and also to stipulate occasions when such activities may be permitted in certain circumstances.\(^\text{49}\) Furthermore, HM Treasury are also authorised to place specific prohibitions on

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\(^{48}\) This essentially covers most financial institutions (including banks, brokers, structured finance vehicles, systemically important insurers, UCITS and their managers and financial holding companies), high net worth individuals and non-SME businesses (or group companies of such businesses), provided they fulfil the relevant criteria as set out in the legislation.

\(^{49}\) Two activities are currently listed as "excluded activities" under Part 2 of The Financial Services and Markets Act 2000 (For further details please see the Excluded Activities and Prohibitions Order 2014 (http://www.legislation.gov.uk/uksi/2014/2080/pdfs/uksi_20142080_en.pdf)), these being "dealing in investments as principal" and "commodities trading". The order also contains a list of exemptions to the excluded activities, contained in Articles 5 to 12.
ring-fenced banks. The annotated version\(^{50}\) of the Banking Reform Act states that the UK government chose to include "prohibitions" in addition to "excluded activities" to encompass any bank conduct that does not fit easily within the definition of "activity". The prohibitions set out in the secondary legislation\(^{51}\) relate to exposures to financial institutions, the use of interbank payment systems and the maintenance/establishment of non-EEA branches and subsidiaries.

Whilst the proposals will undoubtedly have an enormous impact on the structure of affected banks and their product offerings generally, from a loan market point of view, the following points should be noted:

- **Restrictions on exposures by ring-fenced bodies to financial institutions.** The Banking Reform Act gives HM Treasury the ability to impose prohibitions on ring-fenced institutions. Under the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the Excluded Activities and Prohibitions Order), exposures to the following types of financial institution (amongst others) are prohibited:
  
  - credit institutions;
  - investment firms;
  - structured finance vehicles;
  - global systemically important insurers;
  - UCITS (wherever established) and alternative investment funds
  - management companies or alternative investment fund managers; and
  - financial holding companies and mixed financial holding companies,

  (known as "relevant financial institutions" – and defined fully at Article 2 of the Excluded Activities and Prohibitions Order) unless the institution is (amongst other things) a:

  - ring-fenced body;
  - building society;
  - body corporate whose main purpose is to make loans secured on residential property, is funded substantially by its members and is incorporated under the laws of an EEA state other than the UK;
  - investment firm which is not authorised to deal in investments (as principal or agent) in either the UK or EEA; or
  - listed in the schedule to the Excluded Activities and Prohibitions Order.\(^{52}\)

However, under the general prohibition, there are various carve-outs, including:

- incurring financial institution exposures for risk management purposes (e.g. where the purpose of the transaction is to limit the extent to which the ring-fenced body will be

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\(^{50}\) Ibid, (Part 3).

\(^{51}\) Ibid.

\(^{52}\) The schedule largely includes DFIs (e.g. the African Development Bank) and other supranational and intergovernmental bodies such as the EU, the IMF and BIS.
adversely affected by factors such as changes in interest rates, exchange rates, commodity prices, property prices etc) (Article 14(1) to (3);

- incurring intra-group exposures on commercial arm’s length terms (Article 14(4));
- short term exposures arising in the course of providing payment services (Article 14(5));
- certain types of trade finance exposure (Article 15);
- certain types of securitisation exposure (e.g. exposure to sponsored structured finance vehicles of that ring-fenced body and conduit lending) (Articles 16 and 17);
- certain types of repo and reverse repo transactions (Article 18); and
- the provision of certain ancillary services to otherwise prohibited financial institutions (e.g. payment and operational services) (Article 19).

It should be noted that, in relation to the last bullet point above, a ring-fenced body is specifically entitled to act as a trustee or agent in connection with a syndicated loan (provided that the loan is to an undertaking that is not a relevant financial institution). It is also allowed to participate in a syndicated loan to an undertaking which is not a relevant financial institution.

Even in view of the carve-outs, it is difficult to see why the list of prohibitions should be quite so extensive. For example, under present legislation, ring-fenced institutions can lend to large corporates. Such corporates had the opportunity to access either ring-fenced or non-ring-fenced banks to fulfill their borrowing requirements. However, the provision of working capital finance to, for example, investment firms will presumably be prohibited under the current legislation since lending to this sort of entity is essentially an activity which creates a financial institution “exposure” for the ring-fenced bank. It is not clear why a ring-fenced bank should not be in a position to offer loans to both financial and non-financial corporates, especially since the LCR provisions of CRD IV currently require that any facility granted to a “financial customer” is deemed to be 100% drawn, which would mean that the ring-fenced bank’s systemic exposure to the financial institution is already arguably addressed through proposed liquidity regulation.

- **Restrictions on sub-participations.** Ring-fenced institutions will also be prohibited from acquiring loan interests by means of a sub-participation, assuming that the counterparty is a financial institution to which exposures are prohibited. However, ring-fenced entities should be able to acquire loan interests directly (i.e. via transfer/assignment). This represents a concession from the Government’s original proposals, whereby secondary market purchases of loans and other financial instruments by ring-fenced banks were to be expressly prohibited. The LMA had argued in its response to the Government proposals that such a prohibition would be counter-intuitive for the following reasons:

  - there is no difference between a ring-fenced bank lending to a corporate directly in the primary market and acquiring an interest in that same loan via the secondary market, as long as appropriate due diligence is conducted by the purchaser;
  - it is difficult to see why secondary market loan purchases should expose the ring-fenced bank to additional risk or increase systemic risk within the banking system generally;
  - once the proposals are implemented, secondary loan purchases may be the only method by which a ring-fenced bank can lend to a large corporate – especially if the corporate’s relationship is with a non-ring-fenced bank; and
o one of the objectives of prudent portfolio management undertaken by a ring-fenced entity should be an ability to substitute risk-weighted assets as and when required. Secondary loan purchases/sales are an important tool that permits this process to happen and should therefore be an expressly permitted activity.

- Potential restrictions on activity outside EEA. It is also worth highlighting that under the Excluded Activities and Prohibitions Order, a ring-fenced entity may not establish or maintain a branch in a country outside the EEA (Article 20). It may, however, have a participating interest in any undertaking incorporated outside the EEA if that undertaking does not carry on any activities that would be regulated activities under the Financial Services and Markets Act 2000 if carried out in the UK.

B. The Liikanen report and EU proposals

In February 2012, the Commission appointed a "high level expert group" chaired by Erkki Liikanen to make recommendations on the structural reformation of the EU banking sector. Their findings (the Liikanen Report) were published in October 2012. The report covers five main topics: 1) the separation of proprietary trading and market making activities; 2) the separation of any other activities which the regulator considers necessary to ensure a bank’s resolvability (dependent on that bank's recovery and resolution plan (RRP); 3) amendments to the Commission’s bail-in proposals; 4) changes to banks’ capital requirements; and 5) reformation of banks' corporate governance procedures.

As with the UK legislation, although the proposals contained in the report could have enormous repercussions for the European banking sector generally, this guide will focus solely on the separation proposals, which are likely to have the greatest impact on the syndicated loan market.

When will it be implemented?

In May 2013, the Commission published a consultation document, focusing on the part of the Liikanen Report which dealt with structural separation, and requesting input on topics such as which banks should be subject to separation; the scope of activities to be separated; the strength of separation; and how to define "trading activity". The Commission then published its formal legislative proposals (in the form of a regulation) in relation to structural separation on 29 January 2014.53

The Council of the EU and the European Parliament are currently in the process of reviewing the Commission's legislative proposal and on 19 June 2015, the Council agreed its negotiating stance on the structural measures and published its compromise text.54 On the basis of this mandate, the incoming Luxembourg presidency will start negotiations with the European Parliament as soon as the latter has adopted its position. The European Parliament is expected to consider the Regulation during its plenary session in early September 2015. Unless otherwise indicated the information

below and in the footnotes (including Article references) refers to the Council compromise text of June 2015.

It is anticipated that adoption of the final text will not take place until late 2015. If adoption were to take place at this point, the Commission has suggested that any ban on proprietary trading should take effect on 1 January 2017, and the separation powers for supervisors, on 1 July 2018.

**Who will it impact?**

Although the Liikanen Report refers specifically to "banks", the legislative proposal extends to any credit institution or an EU parent, including all branches and subsidiaries, irrespective of where they are located, which are identified as a global systemically important institution in application of Article 131 of the CRD or which exceed certain thresholds relating to size of assets and trading activities ("core credit institutions").

Under the Council compromise text of June 2015, core credit institutions will be prohibited from conducting proprietary trading (Article 6(1)(a)) and from making certain investment activities relating to hedge funds (including incurring uncollateralized exposure to hedge funds via loans and guarantees) (Article 6(1)(b)). Where proprietary trading or those types of investments relating to hedge funds are carried out by entities in the same group as a core credit institution they have to be carried out by a legally, economically and operationally separate "trading entity."

"Proprietary trading" is defined as "using own capital or borrowed money to take positions in any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity’s risk as result of actual or anticipated client activity, through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making, including through dedicated web-based proprietary trading platforms."

In addition to the prohibition on proprietary trading, core credit institutions may also not invest, or hold shares, in hedge funds, or other entities that engage in proprietary trading or sponsor hedge funds. This restriction also prevents the core credit institution from incurring exposures (by granting loans and issuing guarantees) that are not fully collateralised to alternative investment funds that employ leverage on a substantial basis. However, this prohibition does not apply to unleveraged and closed-ended funds, including private equity, venture capital and social entrepreneurship funds. Article 6(2) establishes that the provision, inter alia, of funding, hedging and investment services to clients, market making activities, certain hedging and treasury management activities and

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55 That said, negative scope provisions in Article 4 provide that the Regulation does not apply to branches of third country banks that are incorporated in jurisdictions subject to a legal framework deemed equivalent to that of the EU.

56 Article 5(4). However, this does not extend to trading in EU member states’ government bonds or operating dedicated structures for buying and selling money market instruments for the purposes of cash management (Article 6(2)).

57 Article 6(1)(b). The limitation on incurring exposures through uncollateralized loans and guarantees did not feature in the original Commission proposal but was added in the Council compromise text.

58 Article 6(4). Where the fund in question is located outside the EU, the carve out in Article 6(4) only applies if the fund is marketed in the EU in accordance with the applicable EU marketing regime.
buying and selling financial instruments for long term investment do not constitute proprietary trading.

Beyond the proprietary trading ban, the Council compromise text also envisages that in appropriate circumstances the core retail banking activities of a bank be located in a legally, operationally and economically separate entity from the bank’s remaining activities. The Council text proposes two alternative methods to achieve this: (1) separation of proprietary trading and excessively risky trading activities in a separate entity; or (2) ring-fencing retail banking activities in accordance with national law.

Under the Council text “trading activities" are defined as "an activity that results in positions in financial instruments held on a trading book in accordance with point (86) of Article 4(1) of CRR." The Council text establishes a framework to assess and identify the size and riskiness of banks’ trading activities and divides core credit institutions into two categories – Tier 1 and Tier 2. Pursuant to Article 4a Tier 2 banks are those whose trading activities exceed a 100 billion euro threshold. All other banks would fall into Tier 1. Article 10 provides national regulators with remedial powers over Tier 2 core credit institutions. Where the regulator judges the core credit institution’s trading activities to be excessively risky Article 10 allows the national regulator to impose mandatory separation of trading activities, higher capital requirements and take other prudential measures.

Where a group contains both a trading entity and a core credit institution, Article 13 regulates the relationship between each of them to promote their legal, economic and operational separation. Article 14 imposes intra-group exposure limits.

**How will it impact the syndicated loan market?**

Under the Council compromise text, all forms of proprietary trading will have to be transferred to a trading entity. The core credit institution will also be prevented from making certain investments in hedge funds that employ leverage on a substantial basis (including incurring exposure through loans and guarantees which are not fully collateralized).

Other activities may be carried out by both the credit institution and the trading entity. Again, from a loan market perspective, this includes lending (including interbank lending) and participation in loan syndications. Trade finance activities may also be offered by both types of institution.

**C. Other national regimes**

In addition to the UK, other EU countries have also implemented national regimes of a similar nature. For example, France has passed French law no. 2013-672 of 26 July 2013 on the separation and regulation of banking activities and Germany has passed the Trennbankengesetz (German Bank Separation Law), which is included in Article 2 of the Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen (Law concerning Separation of Risks and Restructuring and Winding-Up of Credit Institutions and Financial Groups), BGBl. 2013 I Nr. 47, 3090.59

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59 The German law was announced on 7 August 2013 and Article 2 entered into force on 31 January 2014. However, most of the requirements set out in Article 2 are only applicable from 1 July 2015.
The French legislation stipulates that proprietary trading in financial instruments and unsecured financing to alternative investment funds (AIF) above a specified threshold set out by decree ("Prohibited Activities") should be carried out by a dedicated trading entity which is separate from the retail function. That said, the legislation does give certain exemptions with regards to proprietary trading. Any Prohibited Activities should be transferred to the trading entity by 1 July 2015. Finally, the legislation also sets out what the trading entity itself can, and cannot, do. For example, it prescribes that it must be licensed by the French regulator; cannot accept deposits that benefit from the deposit guarantee scheme or provide payment services to clients whose deposits benefit from the scheme; and cannot enter into certain types of activity such as high frequency trading and agricultural commodity derivative transactions.

Similarly, the German legislation stipulates that certain high-risk activities above a specified threshold, including proprietary trading (with the exception of market making activities) and loan and guarantee transactions with certain types of AIF and equivalent funds, should be ring-fenced and transferred to a trading entity. However, transactions which are entered into to hedge transactions with certain customers, which are intended for interest rate, currency or liquidity management or are for the acquisition or sale of long-term investments, will still be permitted (unless specifically prohibited by BaFin). The trading entity must be legally, economically and operationally independent from the group's retail function (including having its own capital and liquidity resources) and should interact with the rest of the group on an arm's length basis. Finally, trading entities will not be permitted to provide payment services or operate an electronic payment business within the meaning of the German Payment Services Supervision Act (Zahlungsdiensteaufsichtsgesetz).

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60 These include the provision of investment services to clients, the clearing of financial instruments, the hedging of certain risks incurred by the credit institution or the group, market making activities, the sound and prudent management of the treasury of the group and certain types of investment transactions of the group – see Article L.511-20 of the French Code monétaire et financier.
Section 3

REGULATION OF NON-BANK LENDERS AND SHADOW BANKING

A. AIFM Directive

Publication of the Alternative Investment Fund Managers Directive (2011/61/EU) (AIFMD) followed a general call for more vigorous supervision of alternative investment funds (AIF) throughout the EU.

The aim was to:

- establish "a harmonised framework for monitoring and supervising the risks that alternative investment funds pose to their lenders, counterparties, other market participants and to financial stability"; and

- allow "alternative investment fund managers (AIFM) to provide services and market funds throughout the EU single market, subject to compliance with strict requirements".

When was it implemented?

The AIFMD was published in the OJ on 1 July 2011 and came into force on 21 July 2011, with an implementation date by member states of 22 July 2013.

Following publication of the AIFMD, the Commission has also adopted various delegated regulations and implementing regulations. These include Delegated Regulation 231/2013 of 19 December 2012 (published in the OJ on 22 March 2013) which supplements the AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision; Implementing Regulation 448/2013 of 15 May 2013 (published in the OJ on 16 May 2013) which establishes a procedure for determining the Member State of reference of a non-EU AIFM pursuant to the AIFMD; Implementing Regulation 447/2013 of 15 May 2013 (published in the OJ on 16 May 2013) which establishes the procedure for AIFMs which choose to opt in under the AIFMD; Delegated Regulation 694/2014 supplementing the AIFMD with regard to regulatory technical standards determining types of alternative investment fund managers and finally, Delegated Regulation 2015/514 of on the information to be provided by NCAs to ESMA.

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62 Any transitional provisions ended on 22 July 2014. Even so, not all EU Member States have implemented the AIFMD and it has not yet been incorporated into the European Economic Area Agreement (EEA Agreement). In order to assist with this issue, ESMA published an opinion in August 2013 which set out certain practical considerations. The practical arrangements proposed relate to operations under Articles 31, 32 and 33 of the AIFMD where one member state has not transposed the AIFMD.

63 For links to all the above regulations, please go to http://ec.europa.eu/finance/investment/alternative_investments/index_en.htm.
ESMA has also adopted a variety of Level 3 Guidelines and other informal measures to supplement the AIFMD and which are reviewed from time to time. 64

Although at the European and national level, the legislative process is now more or less concluded (for example, in the UK, the AIFMD has been implemented by HM Treasury Regulations and changes to the FCA Handbook) the Commission is expected to begin a review of the application and the scope of the AIFMD on 22 July 2017. Similar reviews will also take place at national level, e.g. in 2018, HM Treasury is required to review the operation and effect of the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773).

Who does it impact?

The Directive extends primarily to fund managers of AIFs (AIFM) who are established in the EU, regardless of where the AIF is established, as well as non EU AIFMs who manage one or more EU AIFs. That said, it does not extend to those funds covered by existing UCITS legislation but all other "collective investment undertakings" (unless specifically exempted). 65 This includes hedge funds, private equity funds, retail investment funds, investment companies and real estate funds. In addition, the Directive applies to non EU AIFMs marketing AIFs within the EU even if they themselves are based outside it. This means that the Directive, for example, affects US managers who market their funds to European lenders.

That said, it should be noted that not all of the AIFMD’s provisions need apply if the AIFM is a small fund manager (i.e. has assets under management of less than €500mn and all its AIFs are unleveraged and incapable of redemption within the first five years following initial investment. In addition, even if the AIFM fails either the leverage or redemption test, it may still apply to be a small fund manager if it has less than €100mn of assets under management).

A broad summary of AIFM and AIF that the Directive applies to is set out in the following table:

<table>
<thead>
<tr>
<th>EU/NON EU AIFM?</th>
<th>ACTIVITY?</th>
<th>WHERE?</th>
<th>DOES DIRECTIVE APPLY?</th>
<th>WHICH ARTICLE?</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU AIFM</td>
<td>MARKETING EU AIF</td>
<td>IN HOME MEMBER STATE OF AIFM</td>
<td>YES</td>
<td>31</td>
</tr>
<tr>
<td>EU AIFM</td>
<td>MARKETING EU AIF</td>
<td>IN MEMBER STATE OTHER THAN HOME MEMBER STATE OF AIFM</td>
<td>YES</td>
<td>32</td>
</tr>
</tbody>
</table>

64 These include the Final Guidelines on reporting obligations under the AIFMD, which applied from 9 October 2014, Guidelines on Key Concepts of the AIFMD, which applied from 14 October 2013, and Guidelines on Sound Remuneration Policies, which applied from 22 July 2013. In addition, ESMA regularly produces Q&As on the application of the AIFMD and certain Guidelines, such as those relating to remuneration, are under review.


66 In addition to the requirements set out above, EU AIFMs will be required to obtain initial authorisation under Article 7 of the AIFMD, prior to managing or marketing AIFs.
<table>
<thead>
<tr>
<th>EU/NON EU AIFM?</th>
<th>ACTIVITY?</th>
<th>WHERE?</th>
<th>DOES DIRECTIVE APPLY?</th>
<th>WHICH ARTICLE?</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU AIFM</td>
<td>MANAGING EU AIF</td>
<td>AIF ESTABLISHED IN MEMBER STATE OTHER THAN HOME MEMBER STATE</td>
<td>YES</td>
<td>33</td>
</tr>
<tr>
<td>EU AIFM</td>
<td>MANAGING NON EU AIF</td>
<td>OUTSIDE THE EU</td>
<td>YES – APART FROM ARTICLES 21 (Depositaries) AND 22 (Annual Report) IN RESPECT OF AIF</td>
<td>34</td>
</tr>
<tr>
<td>EU AIFM</td>
<td>MARKETING NON EU AIF</td>
<td>ANY MEMBER STATE</td>
<td>YES</td>
<td>35*,36</td>
</tr>
<tr>
<td>NON EU AIFM</td>
<td>MANAGING EU AIF</td>
<td>IN MEMBER STATE OF REFERENCE</td>
<td>YES</td>
<td>37*38</td>
</tr>
<tr>
<td>NON EU AIFM</td>
<td>MANAGING EU AIF</td>
<td>IN ANY MEMBER STATE OTHER THAN MEMBER STATE OF REFERENCE OF NON EU AIFM</td>
<td>YES</td>
<td>41*</td>
</tr>
<tr>
<td>NON EU AIFM</td>
<td>MARKETING EU AIF</td>
<td>IN ANY MEMBER STATE</td>
<td>YES</td>
<td>37*,39* 42</td>
</tr>
<tr>
<td>NON EU AIFM</td>
<td>MARKETING NON EU AIF</td>
<td>IN ANY MEMBER STATE</td>
<td>YES</td>
<td>37<em>40</em> 42</td>
</tr>
<tr>
<td>NON EU AIFM</td>
<td>NEITHER MANAGING OR MARKETING AN AIF IN THE EU</td>
<td>No</td>
<td>NO</td>
<td>N/A</td>
</tr>
</tbody>
</table>

*Articles not yet applicable. They may become applicable in the future by means of delegated act if ESMA issues positive advice that the marketing passport regime should be extended to non-EU AIFMs marketing their non-EU AIFs.

The broad scope of the definition of an AIF also means that it is not altogether clear whether or not CLO managers will be subject to the requirements of the AIFMD, or whether they will be

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67 Article 42 permits non-EU AIFMS to market AIFs in the EEA without a passport.

68 A CLO is a special purpose vehicle which, via a CLO manager, purchases a portfolio of loans. The risk in relation to that loan portfolio is then sold on to investors in the capital markets through CLO notes, which are divided into risk “slices” or tranches.
specifically exempted by falling within the definition of an SSPE. In any event, many CLO managers will manage other types of fund and therefore fall within the requirements regardless.

**How will it impact the syndicated loan market?**

Whilst AIFMD will have an enormous influence on the organisational (and capital) requirements of those lenders who are EU established managers of AIF, there is also a twofold impact on the syndicated loan market itself. Firstly, the administrative burden created by the due diligence requirements may affect the ability/desire of funds to invest in loans. Secondly, some parts of the Directive will impact the loan as a product directly.

Some of the key issues that AIFMs should consider when investing in loans are as follows:

- **Valuation of assets.** The valuation of assets that are not financial instruments must take place at least once a year (and "every time there is evidence that the last determined value is no longer fair or proper") and be done either by the AIFM or a professional external valuer. An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified. Clearly, loan investments will need to be valued as part of this process. No specific procedure is set out by the Commission, although it stipulates that detailed, consistently applied and periodically reviewed policies and procedures be put in place setting out the valuation methodologies. Furthermore, prices must be obtained from independent sources (where possible) and individual assets must be fairly and appropriately valued and also subject to a carefully considered review process where "a material risk of inappropriate valuation exists" (e.g. the valuation is based on prices only available from a single counterparty or broker source). Given that loans are not priced via an official trading venue, fund investors must consider the best way of valuing loans and put controls in place to ensure that an appropriate degree of objectivity is brought to bear when considering values obtained from external sources (e.g. counterparties). In addition to having to value individual assets, loan investments will also need to be valued as part of the general process of calculating the net asset value of an AIF (which will be necessary if AIFM who manage smaller AIF wish to seek an exemption from the requirements of the AIFMD). Again, no specific procedure for valuation is set out by the Commission.

- **Professional negligence risks to be covered by additional own funds, professional indemnity insurance or a combination of both.** Potential liabilities arising from professional negligence include negligent loss of documents evidencing title of assets and failure to undertake sufficient due diligence on an investment. Fund managers must therefore be conscious of their obligation to undertake detailed due diligence when investing in loans and the need to be able to demonstrate good title in order to evidence ownership. Given that many loan processes are executed manually, extra care may need to be taken in relation to direct loan investments.

- **Duty to act in the best interests of the AIF or the lenders of the AIF and the integrity of the market.** Amongst other things, AIFMs must act in such a way so as to prevent "undue costs" being charged to the AIF and must also perform any due diligence prior to execution. Measures such as these could lead to fund managers requiring more streamlined market practices, particularly in the secondary market, where settlement delays often lead to capital being tied up for periods of time, resulting in AIFMs suffering potential "opportunity costs" by virtue of the
fact that they are unable to invest in other assets until settlement takes place. It may also lead to greater focus on the need for transparent trading in order to avoid any allegations of malpractice.

- **Due diligence requirements.** The amount of due diligence (DD) required should be proportionate to the relevant asset. There will also be additional DD requirements for AIFM managing AIFs which invest in long duration, less liquid assets. It is not clear whether loans fall into the category of "long duration, less liquid assets" (the examples given include real estate and partnership interests). If they do, AIFMs must undertake more detailed DD, including "during the negotiation phase" of the agreement.

- **Risk and liquidity management.** AIFMs should establish a risk management function (separate from the operating units) and implement and maintain both a risk management policy and quantitative and qualitative risk limits. They should\(^69\) also set up a liquidity management system, adopt appropriate liquidity management policies to monitor the liquidity profile of the AIF’s portfolio of assets, implement liquidity limits and conduct appropriate stress tests under normal and exceptional liquidity conditions. Loan investments will therefore need to be assessed in terms of underlying risk and liquidity under both normal and exceptional liquidity conditions.

- **Investment in securitisation positions.** AIFMs should only assume exposure to the credit risk of a securitisation position on behalf of one or more AIFs if the originator, sponsor or original lender has explicitly disclosed to the AIFM that it will retain, on an ongoing basis, a net economic interest which in any event should not be less than 5%.\(^70\)

- **Duties of the depositary.** The depositary has two primary functions: to safekeep the AIF’s assets and to oversee its compliance with the AIF’s rules and instruments of incorporation and with applicable law and regulation. The Directive further requires the depositary to ensure the AIF’s cashflows are properly monitored.

With regards to the safekeeping of assets, loans will fall within the "record keeping" (as opposed to the custody) requirements, for which two obligations are imposed on the depositary. The first one is to verify the ownership of the assets of the AIF and the second is to maintain a record of those assets for which it is satisfied the AIF holds the ownership. The Commission has clarified that "maintaining a record" means registering the assets in its name in the first instance, or setting up a procedure to receive information from third parties where the assets are registered in the name of the AIF. In any event, the depositary must be able to ensure it is able, at any time, to provide a comprehensive and up-to-date inventory of all the AIF’s assets.

In order to fulfil these obligations, the depositary should:

- ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions; or

\(^{69}\) Except in the case of unleveraged, close-ended AIF.

\(^{70}\) This requirement is part of a wider regulatory proposal with regards to risk retention requirements imposed on certain parties to a securitisation. Risk retention requirements and their impact on the loan market are discussed in more detail later in this Section.
• have access to documentary evidence of each transaction and positions from the relevant third party on a timely basis.

Loan investments will fall within these requirements and depositaries are therefore likely to take greater interest in documents evidencing title and the loan title transfer process going forward.

With regards to the depositary’s oversight functions, a key loan-related duty is that of ensuring the timely settlement of transactions. To fulfil its obligations, the depositary must set up procedures to detect any situation where consideration is not remitted to the AIF within the "usual time limits". It is not clear what these will be in relation to loan settlement, given the varying nature of settlement times in the secondary market. Different depositaries may well take different views, but interest in loan settlement times is likely to increase as a result.

• Leverage. In addition to requiring an AIFM to set a maximum level of leverage for each AIF that it manages (which must be reasonable and set in accordance with certain pre-determined criteria) the Directive also enables competent authorities, under certain conditions and according to specified procedures, to exercise supervisory powers to "impose limits on the level of leverage that AIFM are entitled to employ or other restrictions...to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets". Depending on the extent of the leverage requirements imposed, general loan market liquidity could be impacted as a result.

B. Regulation of shadow banking

1. The international response

Efforts to improve the regulation and oversight of shadow banking from an international perspective have been coordinated at an international level by the Financial Stability Board (FSB)\(^71\), at the request of the G20.

On 27 October 2011, the FSB published a report\(^72\) which outlined its recommendations in relation to the risks posed by the shadow banking industry. The report defined shadow banking as "credit intermediation involving entities and activities (fully or partly) outside the regular banking system," or "non-bank credit intermediation" in short.

On 18 November 2012, the FSB published its overall approach to shadow banking regulation in a consultation document entitled "An Integrated Overview of Policy Recommendations".\(^73\) In this document, the FSB highlighted (amongst other things):

• The need for enhanced monitoring of the shadow banking system generally.

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\(^71\) It is worth noting that the FSB is a policy setting body and therefore any actual legislation must be implemented by national regulators. That said, the FSB do undertake "peer reviews" in order to keep track of progress on implementation across the G20 members.

\(^72\) http://www.financialstabilityboard.org/publications/r_111027a.pdf

\(^73\) http://www.financialstabilityboard.org/publications/r_121118.pdf
• The need to reduce exposure of the regular banking system to the shadow banks and reduce the opportunity for regulatory arbitrage.

• The importance of regulating those entities/vehicles which carry out the same activities as banks.

The FSB published its **final policy recommendations** on 29 August 2013.\(^\text{74}\) On 14 November it published its Progress Report on transforming shadow banking into resilient market-based financing.\(^\text{75}\)

As well as having a general approach to shadow banking, the work of the FSB is split into two further key areas: a) "a system-wide monitoring framework" that tracks developments in the shadow banking system and initiates corrective actions (to the extent necessary); and b) the coordination of "policy measures in five key areas where oversight and regulation should be strengthened", in order to reduce excessive build-up of leverage, as well as maturity and liquidity mismatches.

**a) System-wide monitoring framework**

To achieve its aims in this regard, the FSB has begun annual monitoring exercises to assess sources of systemic risk which fall both within and outside the realms of prudential regulation. The latest results were published in October 2014.\(^\text{76}\) According to the FSB, these exercises have led to an increasing number of national authorities assessing the risks of shadow banking, with the result that the monitoring now covers 25 jurisdictions, representing 90% of assets in the global financial system and 80% of global GDP.

Going forward, the FSB plans to further improve the process and identify any gaps and data inconsistencies. Implementation of policy measures (see section b) below) should also improve the coverage and granularity of the monitoring exercise generally.

**b) Policy measures**

As part of its remit to develop policy measures, the FSB has set up five work streams to tackle those areas of the industry which it considers to be a priority. These are:

• **Work stream 1 (WS1).** To look at the interaction of shadow banks with the regular banking system (chaired by the BCBS);

• **Work stream 2 (WS2).** To consider regulatory reform of money market funds (MMF) (chaired by IOSCO);

• **Work stream 3 (WS3).** To examine shadow banking entities other than MMF (chaired by the FSB);


• **Work stream 4 (WS4).** To look at securitisation regulation, particularly retention requirements and transparency (chaired by IOSCO); and

• **Work stream 5 (WS5).** To assess the risks associated with securities lending and repos, particularly possible measures on margins and haircuts (chaired by the FSB).

The work undertaken to date in relation to each work stream may be briefly summarised as follows:

<table>
<thead>
<tr>
<th>WORK STREAM</th>
<th>STATUS</th>
</tr>
</thead>
<tbody>
<tr>
<td>WS1</td>
<td>The BCBS has now finalised: (1) risk-sensitive capital requirements for banks' investments in the equity of funds (published in December 2013);(^{77}) and (2) the supervisory framework for measuring and controlling banks' large exposures to single counterparties (published in April 2014).(^{78}) The first of these is to be fully implemented from 1 January 2017 while the second is to be fully implemented by 1 January 2019. In addition to these measures, the BCBS is continuing its review of the scope of consolidation for prudential regulatory purposes, with a view to publishing guidance to ensure all banking activities, including banks' on and off-balance sheet interactions with the shadow banking system, are appropriately captured in prudential regimes. It intends to develop proposals for public consultation by the end of 2015.</td>
</tr>
<tr>
<td>WS2</td>
<td>IOSCO published its policy recommendations for MMFs on 9 October 2012.(^{79}) These included the need for: 1) a general regulatory framework for MMFs; 2) sound liquidity management policies; and 3) rules regarding valuation, credit ratings, use of repos and disclosures made to investors. Since the publication of the recommendations, regulatory authorities have been asked to progress regulatory frameworks for MMFs. In the EU, for example, the Commission issued a proposal in September 2013 for the regulation of MMFs.(^{80}) In November 2014 IOSCO published its key preliminary findings of its peer review into MMF regulation.(^{81}) IOSCO published a final report on the progress of regulatory reform for MMFs in September 2015.(^{82})</td>
</tr>
</tbody>
</table>

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\(^{77}\) [http://www.bis.org/publ/bebs266.pdf](http://www.bis.org/publ/bebs266.pdf)

\(^{78}\) [http://www.bis.org/publ/bebs283.pdf](http://www.bis.org/publ/bebs283.pdf)


| WS3 | The FSB published a consultation document on 18 November 2012 entitled "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities"\(^3\) in which it emphasised the need to approach shadow banking issues "through an economic function-based (i.e. activities-based) perspective, rather than solely through an entities-based perspective". Its recommendations were finalised and published on 29 August 2013.\(^4\) The framework comprises: (1) an assessment of non-bank financial entity types based on five economic functions; (2) the adoption of policy tools to mitigate financial stability risks where necessary; and (3) information sharing by FSB member authorities through the FSB process to maintain international consistency in applying the framework, minimise gaps in regulation and detect new adaptations. Based on the framework, the FSB launched an information sharing exercise in May 2014 followed by a more in-depth analysis of the findings. The results provide the basis for a peer review of members' implementation of the policy framework launched on 2 July 2015.\(^5\) Further policy recommendations may then be published by the FSB. |
| WS4 | IOSCO published its policy recommendations for securitisations on 16 November 2012.\(^6\) Although no further regulation was recommended, since it advocates ongoing monitoring of the implementation of existing regulation, notably risk retention rules, IOSCO carried out a peer review of regulatory approaches and published a preliminary report of the review’s findings on 13 November 2014.\(^7\) A final report is expected during the course of 2015. In addition, the BCBS and IOSCO have established a cross-sectoral working group to identify factors that may be hindering the development of simple and transparent securitisation structures. Following consultation,\(^8\) a report setting out recommended criteria was published in July 2015.\(^9\) The purpose of these criteria is not to serve as a substitute for investors’ due diligence, but rather to identify and assist in the financial industry’s development of simple and transparent securitisation structures. |

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\(^8\) For a link to the LMA’s submission in this regard, please go to [http://www.lma.eu.com/submissions-regulators.aspx](http://www.lma.eu.com/submissions-regulators.aspx).

The FSB published a set of policy recommendations to address shadow banking risks in relation to SFTs in August 2013. Various initiatives have also been started to implement the various policy recommendations. In addition, regulatory authorities have launched their own initiatives. For example, the European Commission has adopted a proposal for a Regulation on reporting and transparency of SFTs in the EU.

In terms of next steps, following the G20 Brisbane Summit in November 2014, the FSB has stated that it intends to take forward its work, based on its "Roadmap" for 2015.

2. The European response

From a European legislative perspective, following the production of a Green Paper by the Commission on Shadow Banking, which was published as a consultation on 19 March 2012 (the Green Paper) and the publication of a Communication in relation to shadow banking on 4 September 2013, a number of regulatory reforms have been introduced which are intended to minimise the risks associated with different types of shadow banking activity. These include:

- measures implemented via banking regulation in relation to bank exposure to shadow banks (CRD IV)
- measures implemented via insurance regulation in relation to insurer exposure to shadow banks (Solvency II)
- measures in relation to the asset management sector (AIFMD, UCITS VI)
- proposals to reduce risks associated with SFTs (via the Securities Financing Transactions Regulation)
- proposals to reduce risks associated with MMFs (via a proposed regulation)
- enhanced transparency of shadow banking activity (to be achieved via legislation such as EMIR and MiFID)
- reform of rating agencies (CRA 3)
- Resolution tools aimed at non-banks


The EBA has also published a consultation paper on draft guidelines setting out criteria that set limits on EU institutions’ exposures to shadow banking entities.\(^{94}\)

**Who will it impact?**

In addition to providing specific recommendations in relation to MMFs and SFTs (both of which are outside the scope of this guide) an emphasis has been placed by both the FSB and the Commission with regards to the importance of looking at shadow banking activities, as opposed to entities. For example, the EBA Consultation has defined shadow banking entities as those that:

"...carry out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and are not within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks). Entities referred to in Article 2(5) and Article 9(2) of Directive 2013/36/EU (CRD) are also not to be regarded as shadow banking entities."

**How will it impact the syndicated loan market?**

The real concern with regards to any proposed regulation of the shadow banking industry is that it may inadvertently capture entities and activities which pose very little risk to the financial system and as a result, simply have the effect of reducing non-bank liquidity in the financial markets, at a time when such liquidity is necessary to ensure future economic recovery. Obviously, a reduction in non-bank liquidity will have a detrimental impact on the syndicated loan market in the same way as it would for any other market.

Although more clarity and guidance from both the FSB and the Commission is required before it becomes possible to assess the true nature of the consequences of shadow banking regulation, it is very likely that, at some point, shadow banking entities will be subject to a certain amount of bank-like regulation, such as limits on leverage, capital requirements, liquidity buffers and restrictions on exposures to, and receipt of funding from, banks and other financial entities. With this in mind, some of the key issues to be aware of from a loan market perspective are as follows:

- **Definition of shadow banking.** Whilst it is positive to note that there is now a move away from the original proposals, which attempted to categorise shadow banking by vehicle type rather than the activity carried out, concerns remain regarding the overarching definition. For example, looking to the EBA’s definition (which is the most recent) concerns remain that:
  
  o shadow banking entities are still defined too broadly and without an adequate assessment of which activities fall within the definition. For example, the proposed definition would capture any entity whose business happens to include lending or credit, regardless of whether this is the entity’s main business;

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- the general reference to "bank-like activities could be seen to cover any entity whose activities involve "maturity transformation" and/or "leverage". Although it appears that for the purpose of the EBA guidelines these activities must be "bank-like", further clarification is required as to exactly what this means; and

- banks will be required to make a determination on a borrower-by-borrower basis as to whether a particular customer falls within this definition. Assuming that it will not be permissible simply to accept a borrower's undertaking that it does not engage in these activities, it will be necessary for each bank to establish a set of metrics to classify borrowers. Such metrics will presumably have to be objective rather than judgement-based, and based on publicly available data. It is almost impossible to envisage such a system not coming up with significant unintended consequences; the most important of which is that commercial businesses whose data inadvertently contravenes such metrics may find themselves cut off from the banking system as a whole as a source of finance. Given the number of borrowers this could capture, this could be a very difficult task to manage.

- **Entities to be regulated.** The EBA lists examples of entities that carry out credit intermediation and this includes a broad list, for example special purpose vehicles. Shadow banking should be identified by reference to economic activity and not vehicle type on the basis that the same sort of "entity" for labelling purposes can pose very different levels of risk. In addition, entities that do not feature in a pre-determined list could carry out the same activity as one that does. Simply regulating entities by way of vehicle categorisation is potentially dangerous, and could lead to unintended consequences for low risk investment vehicles. Furthermore, it would be difficult to categorise shadow banking entities accurately, particularly given the rate of financial product/vehicle evolution, which could potentially render any definitions outdated within a short space of time.

- **Costs of implementing new regulation.** It should be recognised that an unavoidable consequence of imposing new regulatory requirements on previously unregulated entities will increase operational costs across the board. Although such costs may be deemed necessary, given that many shadow banking vehicles are relatively small (particularly when compared to banks) any costs must be proportionate in order to prevent non-banks withdrawing from the market altogether and creating further funding gaps within the financial markets.

In order to mitigate these concerns, the LMA has lobbied the EBA and suggested that it introduce a concept of materiality into the guidelines, in the same way as has been done for CRD IV. This would result in a borrower only being classified as a shadow banking entity to the extent that any relevant activity was carried out as "its main business".  

In the view of the LMA, by adding a concept of materiality, companies which carry out these activities as an ancillary part of their business would not be caught by the legislation. This would permit banks to make a practical and meaningful assessment as to whether an entity falls into the definition.

Overall, unless appropriate focus is given to the true nature of the risks to be regulated, there is a real danger that ordinary non-bank lenders could be prevented from investing in assets such as loans...
(or at least be required to comply with arduous regulation before being able to do so). This seems particularly unnecessary given that many non-bank lenders are already arguably appropriately regulated by direct measures such as AIFMD, the UCITS Directive, CRA 3 and MiFID, as well as indirect regulation such as CRD IV and Solvency II.

C. CLOs and securitisation regulation

In the years since the financial crisis first began, a large amount of regulatory reform has been published which specifically targets securitisations, both by international policy makers and national regulators. Whilst, initially, such regulation resulted in the securitisation market all but closing, there is now some recognition that securitisation is a necessary feature of the financial markets and an important source of funding. As a result, there are now moves at both an international and national level to categorise and differentiate between different types of securitisation so that those that are considered "safer" and which meet certain standards, may benefit from more favourable regulatory treatment which, at the very least, is more directly comparable to other types of financial product. For example, under the LCR Delegated Regulation, (see Section 1 above for more details), the Commission has already extended the range of securitisation instruments that are eligible as level 2b HQLA for credit institutions' liquidity buffers to include auto, SME and consumer loans in addition to RMBS. However, to qualify for these purposes, ABS instruments will have to meet certain "high quality" requirements (and will be subject to certain haircuts). Such requirements are identical to those that will apply under the Solvency II Delegated Regulation, but in addition, they will be subject to certain additional requirements specific to liquidity, such as a minimum issue size (EUR 100 million) or a maximum weighted average life (no more than five years).

Although the regulatory regime for securitisations is largely outside the scope of this guide, it does become relevant to the syndicated loan market in the context of managed CLOs. This guide will therefore focus on those aspects which specifically impact the CLO market.

What is a managed CLO?

CLOs are an important feature of the syndicated loan market on the basis that they seek to invest in, and subsequently securitise, the debt of sub-investment grade corporates. However, CLOs differ from most static-pool securitisations in some fundamental ways, most notably because a CLO is not a balance sheet capital tool. Rather, it is a securitisation investment offering investors tranched exposure to a managed pool of corporate debt.

During the warehousing period, prior to issue of bonds by the CLO vehicle, the CLO vehicle accumulates assets that meet certain eligibility criteria from the open loan market. Once these assets reach a critical mass, the CLO vehicle securitisises them by issuing notes to investors in the market. A CLO portfolio will not usually be complete on closing of the securitisation. Instead, following note issuance, the CLO manager will continue to purchase assets on behalf of the CLO vehicle, using the proceeds from the note issuance, right up until the target value of the portfolio is reached. This "ramp up" period may continue for up to six months after closing.

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95 Markets in Financial Instruments Directive – discussed in more detail in this Section three.
There then follows a reinvestment period (typically four to five years after closing) during which time the manager can: a) trade assets up to a certain percentage (usually 20-30% annually), as well as any assets which are "credit improved", "credit impaired" or defaulted, provided the new assets meet the eligibility criteria and certain tests are met; and b) reinvest principal proceeds from the assets in buying new ones.

After the reinvestment period finishes, unscheduled principal repayments received from the underlying assets, as well as sale proceeds from "credit improved" and "credit impaired" assets may be reinvested by the CLO manager (to the extent that they are not required to pay items in the principal priority of payments such as any interest shortfalls on senior notes). Other principal receipts after the reinvestment period are used to redeem the notes sequentially, and many deals also have a clean-up call once the portfolio falls to 15-20% of its original target size.

The regulatory impact on the CLO market may be broken down into the following categories:

a. **Proposed EU framework for simple, transparent and standardised (STS) securitisations**

In addition to the rules already in place under both CRD IV and Solvency II, the Commission is now seeking to develop an overarching EU framework for "simple, transparent and standardised" or STS securitisation – an initiative which has come about has come about as part of a policy decision to rekindle the European securitisation markets. It also follows consultations published by a number of central banks, governments, and supranational and international authorities such as the ECB, BoE, BCBS and IOSCO.\(^6\) This is ultimately likely to result in the formulation of a set of generic rules to ensure simplicity, transparency and standardisation of securitisation instruments (i.e. a product where the risks of the transaction can be properly understood and modelled, based on the information made available to investors in the transaction).

Although the outcome of such consultations is not yet clear, it seems likely that qualifying securitisations that meet this new set of criteria will benefit from more attractive regulatory treatment, e.g. lower risk weightings for securitisation assets held by bank investors.\(^7\) Indeed, an early version of the qualifying securitisation concept has already been incorporated into the Solvency II Delegated Act, where investments in “Type 1” securitisations (that meet certain criteria) are subject to lower capital charges than “Type 2” securitisations (that do not). A similar approach looks likely to be set out for banks once European criteria for qualifying securitisation are agreed and adopted. The expectation is that the criteria for insurance undertakings would then be revised and harmonised with the general criteria adopted for securitisations by the European Commission.

Although it is still unclear as to how capital relief will be granted to banks investing in securitisations, the EBA has suggested that whilst it is unlikely to be the same as the capital treatment of the

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\(^6\) To see the LMA responses to such consultations, please visit [http://www.lma.eu.com/submissions-regulators.aspx](http://www.lma.eu.com/submissions-regulators.aspx)

underlying loan, it may be brought closer into line. Since this would result in the treatment of securitisations being at odds to those recommended under Basel III,98 the EBA has recommended that capital charges in the recent revision of the Basel securitisation framework be lowered to reflect the relative risk of qualifying products.99 The BCBS has also indicated that it intends to assess how qualifying securitisations can be incorporated into the Basel III securitisation framework during the course of 2015/early 2016. The publication of a joint document by BCBS and IOSCO relating to criteria for identifying simple, transparent and comparable securitisations in July 2015 would also lead to the conclusion that the Basel III capital framework for securitisations is likely to be amended at some point in the near future.100

There is also a possibility that the present rules for qualification as a level 2b HQLA for the purposes of the LCR will be revisited and harmonised. Put simply, this would mean that a "qualifying securitisation" would (possibly with certain additional criteria being met) also qualify for inclusion as a level 2b asset for LCR purposes. Similarly, certain modifications to the risk retention rules (see part b) below) may also be introduced for qualifying securitisations, thereby making it easier for credit institution and investment firm investors to invest in such assets.

How will it impact the syndicated loan market?

The criteria for qualifying securitisations identified (and in some cases adopted) thus far has given CLO market participants significant cause for concern. This is, among other reasons, on the basis that the current proposals, if implemented, would exclude managed CLOs from being able to qualify as STS securitisations. This is because the portfolio of assets which make up the CLO are actively managed. The LMA has argued that a securitisation should not be excluded simply on this basis, since this is predicated on the belief that active management adds a layer of complexity to a securitisation, which is not the case in the context of a CLO. In addition, there are fears that prescribing a definitive set of criteria to all securitisations is likely to cause a "cliff effect" for those assets which fall outside them since such transactions will automatically be viewed by the market as sub-standard.

The concept of a "simple" securitisation and what that might constitute is also very much subjective. The LMA believes that any criteria that will ultimately be applied to relax liquidity coverage, regulatory capital or risk retention requirements should look to factors such as historical default rates, historical losses, the level of disclosure and transparency and structural features. The criteria should not be framed in such a way as to exclude an entire asset class from qualifying.

In a recent submission to the Commission,101 the LMA has put forward a specific proposal for managed CLOs, suggesting that, provided they comply with the following criteria, they should be included as an STS securitisation:

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98 http://www.bis.org/bcbs/publ/d303.pdf
99 See footnote 92.
101 For a link to the LMA’s submission, please go to http://www.lma.eu.com/submissions-regulators.aspx
• the securitised exposures are managed by a MIFID authorised investment firm or an AIFMD authorised firm (or third country equivalent);

• the CLO manager undertakes to investors in the securitisation that it will comply with the regulatory requirements applying to it (e.g. management of conflicts of interest and management of the securitised exposures);

• the securitisation must contain provisions whereby the interests of the CLO asset manager are appropriately aligned with the interests of the investors for the life of the securitisation (e.g. via payment of an incentive fee which will only be payable upon appropriate performance thresholds having been met);

• investor reports provided monthly; and

• only certain types of structures to constitute a CLO (e.g. high percentage of senior secured loans, no asset-backed securities or synthetic securities and managed by an independent investment firm which selects assets to purchase in the primary or secondary market, without obligation to purchase from any bank or originator).

b. Risk retention requirements

Articles 404-410 of the CRR (previously Article 122a of the Capital Requirements Directive (2006/48/EC and 2006/49/EC) (EU Retention Requirements) provide that a European credit institution will suffer a punitive capital charge if it invests in a securitisation, unless the originator, sponsor or original lender holds a minimum 5% of the net economic exposure of the transaction. Similar provisions now also apply to AIFM under Articles 50-56 of Delegated Regulation 231/2013 and in respect of insurers and reinsurers under Articles 254-257 of Solvency II. The underlying objective of the EU Retention Requirements is to ensure appropriate origination standards in the securitisation market and make sure that interests between originator and investors in a securitisation are aligned.

When was it implemented?

The EU Retention Requirements replaced the provisions of Article 122a in their entirety and came into force on 1 January 2014. In addition, on 13 March 2014, the Commission also adopted a Delegated Regulation (625/2014) published in the OJ on 13 June 2014.\(^\text{102}\) The Delegated Regulation came into force on 3 July 2014, and brought into force the provisions of the final draft regulatory technical standards published by the EBA. The technical standards specify the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk under Articles 404-410 of the CRR.

Whilst the legislative process with regards to risk retention is now more or less concluded, it is possible that any uncertainty following publication of the Delegated Regulation could be clarified either via FAQs or Q&As published by the EBA.

Finally, Article 410(1) of the CRR mandates the EBA to report annually to the Commission on the measures taken and compliance by competent authorities with Articles 405-409 of the CRR. The first of such reports was published on 22 December 2014.\(^\text{103}\) Whilst the EBA has stated that current risk retention requirements are appropriate, it has made some additional recommendations. These include:

- A requirement on the originator, sponsor or original lender to publicly disclose its material net economic interest (this would be in addition to the indirect obligation on the investor to ensure the risk retention requirements are met);
- A narrowing of the definition of "originator" to ensure that it holds genuine economic capital on its assets, and for a minimum period of time; and
- Implementation of globally consistent risk retention rules so as to ensure a level-playing field and to support the cross-border securitisation market.

Who will it impact?

The EU Retention Requirements will capture relevant parties to any securitisation transaction. Specifically from a loan market perspective, the regulation also catches independently managed CLOs.

How will it impact the syndicated loan market?

Whilst the EU Retention Requirements will have a sizeable impact on the securitisation market generally by imposing retention requirements on the originator or sponsor of securitisation transactions (which would obviously extend to any securitisations of loan portfolios) the broad definition of "securitisation" used in the regulation also captures CLOs.

Arguably, CLOs should not fall within the ambit of the regulation for the following reasons:

- Unlike traditional asset-backed securities, the underlying portfolios of CLOs are typically not purchased from one originator or seller but are sourced from the primary or secondary syndicated loan market by regulated investment managers who are independent of any originator or seller of the loans;
- CLO investment managers are able to independently assess the quality of their portfolios and are therefore free of the negative incentives that can arise in an "originate-to-distribute" securitisation model; and
- CLO investment managers are already incentivised to act in the best interest of the CLO lenders through the structure of their fees. The majority of management fees are performance-based and therefore the CLO investment manager will only receive these fees if the CLO is performing

to agreed targets. This compensation structure ensures that the interests of CLO asset managers are appropriately aligned with those of investors in CLOs throughout the life of a transaction.

Regardless of the above, however, and despite the recommendations of IOSCO\(^{104}\) that there be an exemption from retention requirements for managed CLOs, CLOs remain subject to the EU Retention Requirements, which has impacted on new issuance. As managers have encountered difficulties funding and holding the retention and the related capital, investors have struggled with the requisite assurance that the transaction is compliant in the event that any mechanism is used other than simply holding and funding the retention from its own balance sheet. Some of the present difficulties encountered by CLOs are as follows:

- **Who can retain.** Article 405 of the CRR requires that an "originator", "sponsor" or "original lender" act as retention holder in order to satisfy the retention requirements. A "sponsor" is required to be either a "credit institution" or an "investment firm" (Article 4(1)(14)). An "investment firm" is further defined as an entity that is authorised under MiFID and engaged in activities other than asset management. This definition makes it impossible for many CLO managers to act as a "sponsor" retention holder. For example, European CLO managers who purely engage in asset management and take no principal risk, US CLO managers and managers authorised under AIFMD are excluded. This leaves these entities no option other than to act as an "originator" retention holder.

- **Acting as originator.** In the "Draft cost-benefit analysis/impact assessment" published by the EBA alongside the regulatory technical standards on risk retention, the EBA specifically recognises the issues the current framework presents for the CLO market. The EBA also acknowledges that "this could potentially translate in the long term into a modification of the currently existing managed CLO model." CLO managers have already sought to modify the way in which they do business in order to comply with the retention rules, with the biggest challenge being raising the necessary capital to meet the requirements. Where the CLO manager cannot act as a "sponsor", this has been achieved by the use of "originator" entities. Consequently, the suggestion that regulators may narrow the definition of "originator" even further in order to avoid potential misuse could have a very detrimental impact on the CLO market.

- **Funding the cost of retention.** CLO sponsors meet the retention requirement using one of two of the five retention options – option 405(1)(a) (vertical slice) or option 405(1)(d) (first loss). This has resulted in significant increases to capital requirements for CLO managers (who previously did not take credit risk and therefore calculated capital based on their fixed overheads). By way of example, if a CLO manager holds the retention by way of first loss, assuming an unrated tranche of subordinated debt, it must apply the standardised approach to credit risk – i.e. apply a 1250% risk weight to its securitisation position. With a typical deal size being around €400mn, a 5% holding will require capital of €20mn. As well as their own capital cost, most CLO managers will require funding for the purchase of the retention positions. This results in additional cost to the CLO manager.

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In addition, further concerns have been expressed following a Commission consultation relating to an EU framework for STS securitisation, published in February 2015, which suggested that the Commission was considering adjusting the risk retention rules for qualifying instruments. If managed CLOs fall outside the definition of an STS securitisation, it is likely that this market will struggle even further.

D. Credit Rating Agency Regulation

The Credit Rating Agency Regulation III (462/2013) (CRA III), makes significant changes to the existing legal framework on credit rating agencies (CRA) in Europe. CRA III was drafted primarily to resolve the issue of over-reliance on external credit ratings, as well as deal with issues relating to sovereign debt ratings, competition in the CRA industry and the civil liability of CRAs.

Article 8 of CRA III (which is the most relevant provision to the syndicated loan market) sets out the new rules on the rating and provision of information on structured finance instruments (SFI). In particular, Article 8(b) imposes an obligation on issuers, originators and sponsors established in the EU to disclose specific information on SFIs on an ongoing basis, using a website set up by ESMA. The view of the European authorities is that by encouraging issuers, originators and sponsors to work with ESMA to disclose information about underlying debt instruments, it will enable investors to have sufficient public information available to enable them to undertake a proper assessment of the credit quality and performance of the underlying assets of SFIs and, in turn, reduce the issue of over-reliance by investors on external credit ratings.

In addition, Article 8(c) of CRA III requires issuers and related third parties soliciting credit ratings for an SFI to engage two independent CRAs and issue two independent credit ratings on the same debt instrument. The purpose of this is to improve the accuracy of capital requirement calculations relating to these types of products, as required under the CRR, and avoid a situation where a significant downgrade by one CRA has a sizeable impact on the issuer by enabling firms to take to take into account the credit rating provided by another CRA.

When was it implemented?

CRA III was published in the OJ in May 2013 and came into effect on 20 June 2013.

Under Article 8(b), ESMA was required to develop draft regulatory technical standards (RTS) which would set out, more specifically, the nature of the information required under the new disclosure rules, the frequency with which such information would need to be updated and a standardised disclosure template to ensure that the entities to which the disclosure obligation applied complied with the requirements of Article 8(b). This was duly produced, and on 6 January 2015, a Commission Delegated Regulation (the CRA Delegated Regulation), containing the RTS for SFIs was published in

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107 In addition to the regulation, it is worth noting that there is also a Credit Rating Agency Directive (2013/14) which amends, amongst other things, legislation relating to UCITS and the rules applicable to AIFMs in order to reduce over-reliance on external ratings by fund managers who are subject to the directives concerned.

the OJ, applicable from 1 January 2017. On 23 March 2015, ESMA published its final report on guidelines on periodic information to be submitted to ESMA by CRAs. The guidelines themselves were published in June 2015.

Article 4 of the RTS states that the disclosure obligation in Article 8(b) will apply to SFIs backed by the following underlying assets:

- residential mortgages;
- commercial mortgages;
- loans to SMEs;
- auto loans;
- loans to consumers;
- credit card loans; and
- leases to individuals or businesses.

The information required by CRA III will be published on a website once set up by ESMA.

The RTS also state that ESMA will need to communicate, among other things, details of how information is to be transmitted and formatted. This will take place in the form of technical reporting instructions. These technical instructions are to be published by 1 July 2016 to enable the entities to which the disclosure obligation apply, to develop adequate systems to ensure future compliance.

**Who will it impact?**

Recital 2 of the CRA Delegated Regulation states that CRA III is to apply to all financial instruments or other assets resulting from a securitisation transaction. Securitisation is very broadly defined and will therefore capture relevant parties to any securitisation transaction, as well as CLOs. That said, whilst managed CLOs are within the scope of Article 8(b), the RTS currently only apply to the categories of asset-backed securities for which there are existing disclosure templates (see above Article 4 list). ESMA has stated however that in the future, there will be further disclosure templates published, as well as associated reporting obligations. Such new templates will then have to be adopted by the Commission through an amendment of the CRA Delegated Regulation.

**How will it impact the syndicated loan market?**

A key issue that arises in relation to the disclosure obligation generally under Article 8(b) concerns borrower confidentiality. CLO managers purchase and sell loans which are often based on market standard loan documents, including the LMA recommended forms, which contain a variety of

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111 Article 4(1) (61) of the CRR
restrictions around confidentiality. For example, it is very common to see a restriction on the disclosure of confidential information about the borrower, except in limited circumstances. The very extensive and public nature of the disclosure obligation contemplated by Article 8b is likely to impact CLO issuers by requiring them to disclose information to the market which would be in direct breach of their duties of confidentiality to borrowers, whether or not these duties arise under general law in any particular jurisdiction, or are set out in loan documentation. Furthermore, in some jurisdictions (such as France) it may not be possible to agree to contractually disapply such duties.

A breach of confidentiality is also of specific concern in the CLO market, where the number of underlying borrowers is much more limited. As a result, it might be possible to identify the underlying borrowers in a CLO portfolio when information disclosed on the ESMA website is combined with other publicly-available information provided by data providers.

In addition, there are also industry concerns regarding the detail of disclosure of loan level information. CLO investor reports contain a great deal of detail on each loan, including principal balances, purchase price, whether the loan is performing etc. However, this information is subject to any confidentiality requirements applicable to lenders and it would therefore seem more appropriate for CLO managers to disclose the information currently provided in CLO investor reports, which enable confidential information on borrowers to be omitted or redacted.

Finally, it is also worth noting that a Call for Evidence was published on 20 March 2015, which considered the extension of the disclosure requirements to private and bilateral transactions for SFIs. The LMA responded on this and put forward that whilst it was not necessary to define private transactions in SFIs separately to bilateral transactions for the purpose of disclosure, it was crucial that different disclosure obligations apply, as compared with public transactions. In addition, the LMA also put forward that intra-group transactions should be treated as a separate category of private/bilateral transactions. However, whether these types of transactions will come under the ambit of the RTS remains uncertain.

Since the publication of the responses received in relation to the Call for Evidence, the Joint Committee of the European Supervisory Authorities published a report, in May 2015, which contained several recommendations which could have a direct impact on the disclosure requirements under CRA III.112 For example, the report stated that current disclosure requirements under CRA III should be amended in such a way to allow investors to conduct their own due diligence through access to loan level data at the date of marketing/offering the transaction.

E. MiFID 2

In October 2011, the Commission issued proposals to revise the Markets in Financial Instruments Directive, consisting of a directive (MiFID) and a separate regulation (MiFIR) (collectively, MiFID 2). These proposals were intended to replace the current version of the Markets in Financial Instruments Directive (2004/39/EC) which came into force on 1 November 2007 and which regulates investment firms carrying out investment business throughout the EEA. The introduction of both a directive and regulation as part of the revised proposals is to reflect the fact that certain provisions

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are to be uniform across all members states (MiFIR) whilst some require the ability to be interpreted more flexibly (MiFID).

The aims of MiFID 2 are to:

- create more efficient and resilient financial markets;
- take account of technological advancements made since the publication of the original legislation;
- improve transparency in both the equity and non-equity markets;
- improve supervisory powers over investment firms generally;
- introduce an enhanced framework for the commodity derivatives markets; and
- reinforce investor protection.

**When was it implemented?**

Both MiFID and MiFIR were published in the OJ on 12 June 2014. Whilst member states must adopt the measures relating to MiFID by 3 July 2016, and apply the provisions from 3 January 2017, MiFIR will apply automatically from 3 January 2017 (subject to a few exceptions).

With regards to Level 2 measures, on 29 June 2015, ESMA published its first final report on draft ITS and RTS relating to authorisation, passporting, registration of third country firms and cooperation between competent authorities under MiFID 2. The final report covers the majority of the draft ITS and RTS on investor protection topics that ESMA is expected to develop. ESMA has stated that the remaining draft technical standards will be published by the end of 2015.

**How will it impact the syndicated loan market?**

It is generally accepted that the syndicated loan product is not directly affected by MiFID 2 or MiFIR. This is by virtue of the fact that a "loan" is not commonly regarded as constituting a "financial instrument" – i.e. it does not fall within the list of products listed in Section C of Annex 1 of MiFID 2. This is based, however, on the legal assumption that loans do not constitute "transferable securities" – i.e. they are not "classes of securities which are negotiable on the capital market". However, whilst loans themselves may be unaffected, the proposals will impact lenders generally by virtue of who they are (investment firms/credit institutions) and the services they provide (investment services or activities in the EU). In addition, since structured finance products are now specifically caught by MiFID 2, certain loan-related products (such as CLOs) will also be directly affected.

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Applicability of MiFID 2 to structured loan products

The applicability of MiFID 2 to investment firms generally and the way in which it will impact the industry from an operational perspective are beyond the scope of this guide. However, since MiFID 2 will now cover a greater number of financial products and services which are not currently covered, in the loan market context, firms offering structured loan products should be aware of the following changes from a product offering perspective:

- **Transparency and transaction reporting.** Non-equity products (which specifically include CDOs) will be subject to the transparency regime, with requirements being tailored to each financial instrument and for different types of trading. For example, in respect of structured finance products traded on regulated markets, trading venues will be required to make public current bid and offer prices on a continuous basis during normal trading hours (unless granted a waiver) as well as price, volume and execution times as close to real time as is technically possible. Transaction reporting requirements will also be extended.

- **Conduct of business rules.** Investment firms must provide information as to the type of advice provided and give on-going assessments of the suitability of the financial instruments recommended to clients (except for transactions between eligible counterparties). Although no big changes are envisaged to the client classification regime per se, there will now be greater information disclosure requirements, to include periodic communications to clients (including eligible counterparties) which consider the type and complexity of the financial instruments in question, the nature of the service provided to the client and, where investment service advice is provided, how the advice meets the personal characteristics of the client.

- **Overarching requirement to act honestly, fairly and professionally.** This will now be extended to eligible counterparties, taking account of the nature of the eligible counterparty and its business.

- **Corporate Governance.** New corporate governance rules will be introduced for management bodies of investment firms, regulated markets and data service providers. For example, firms will now need to establish nominee committees to assess compliance. Investment firms must also keep records of telephone conversations and electronic communications involving concluded transactions. These must be provided to clients on request and kept for a period of three years.

- **Increased powers of competent authorities.** National supervisors will have the power to ban specific products, activities or practices where these are deemed to be a threat to lenders, the markets or the financial system. ESMA will be given wider powers to temporarily prohibit specific products, activities or practices in certain circumstances (e.g. where the competent authority has not taken action to address the threat).

In light of the above, MiFID 2 will result in changes to the way in which firms offering structured loan products operate and may therefore necessitate changes to loan market practices in relation to such products.
Section 4

TAX

A. FATCA

On March 18 2010, the United States enacted the Foreign Account Tax Compliance Act (FATCA) the aim of which was to increase transparency in the financial markets and, more specifically, to make it difficult for US taxpayers to hold unreported assets outside the United States.

FATCA not only contains various foreign tax compliance provisions, but also imposes a 30% withholding tax on payments (including, amongst others, dividends, interest and principal) from investments in US financial assets paid to non-US banks, financial intermediaries and investment vehicles, unless certain reporting requirements are met.

When FATCA was first enacted, many financial institutions were concerned that compliance with FATCA could be unlawful in the jurisdictions in which they operate, for example because passing information to the IRS would breach data protection requirements. To alleviate these concerns, an increasing number of jurisdictions have signed (or are in the process of negotiating) "inter-governmental agreements" (IGAs) with the US. There are two principal models of IGAs. Model 1 requires all local financial institutions to provide FATCA reporting to the local tax authority (e.g. HMRC in the UK), who will pass it to the IRS; as a result, financial institutions acting out of a Model 1 IGA jurisdiction will, in most cases, be automatically treated as participating FFIs. The Model 2 IGA enables local financial institutions to directly enter into an FFI agreement with the IRS pursuant to which certain reporting requirements apply.

In addition to the above, FATCA may also impose an additional "pass-thru" withholding requirement on non-US source payments. Pass-thru withholding will not be imposed before 1 January 2017 and is currently undefined.

How does FATCA impact the syndicated loan market?

When FATCA was first enacted, the position of financial institutions worldwide was unclear, as was the exact application of FATCA in many circumstances. As such, for a number of years post its introduction, FATCA had a significant impact on loan market practices, particularly when lending into the US.

Following the development of FATCA, the introduction of the IGAs and consequential changes to domestic law in many jurisdictions since the introduction of FATCA, FATCA is much more settled and accordingly, its impact on the syndicated loan market is reducing.

In the case of syndicated loans where the agent is in a Model I IGA jurisdiction and all lenders are in IGA jurisdictions, FATCA should not generally have a significant impact and the FATCA provisions which have now been incorporated by the LMA into the majority of its suite of facility documentation should generally be appropriate.\(^{115}\) Where this is not the case, the FATCA position

\(^{115}\) [http://www.lma.eu.com/documents.aspx?c=35](http://www.lma.eu.com/documents.aspx?c=35). Such provisions provide that obligors, lenders and the agent are all entitled to withhold tax when required by FATCA and do not need to gross-up payments. This means that any lender which is not FATCA compliant by the applicable time limit risks receiving interest (and even principal) net of FATCA
will need to be carefully considered on a deal-by-deal basis, in light of the factual background and the commercial deal, and the cost of any potential FATCA withholding should be appropriately allocated as there is no simple "drafting" solution to FATCA. A separate FATCA summary note has been published by the LMA for those instances in which the FATCA language in the LMA facility documentation is considered to be unsuitable\(^\text{116}\) and the possible approaches to FATCA therein should be considered.

**B. BEPS**

On 19 July 2013, the Organisation for Economic Co-operation and Development (OECD) published an Action Plan on Base Erosion and Profit Shifting (the BEPS Action Plan). One of the underlying aims of the BEPS Action Plan and the related work undertaken by the OECD since that point, is to offer solutions to the perceived use of tax loopholes available via double tax treaties and other tax laws by large multinational companies, enabling them to artificially "shift" profits from high to low (or no) tax jurisdictions.

The BEPS Action Plan, which was endorsed by the G20 in July 2013 (and which identified 15 key areas to be addressed during the course of 2015) has since translated into the publication of a set of deliverables consisting of seven reports which deal with seven of the key areas of the BEPS Action Plan (the 2014 Deliverables). These will remain in interim/discussion form until a further set of deliverables addressing the remaining eight key areas (the 2015 Deliverables) have been published and finalised. The two reports will then be consolidated to create a final package of recommendations which will be delivered to the G20 Finance Ministers in October 2015, together with a plan for follow-up work and a timetable for implementation.

Of the various actions, Action 6 of the BEPS Action Plan\(^\text{117}\) (contained in the 2014 Deliverables) is the most relevant to the syndicated loan market. Action 6 targets "treaty shopping" i.e. a treaty benefit obtainable when an investor who is not entitled to the benefit of a tax treaty, invests via an entity in a different jurisdiction which is. In particular, Action 6 aims to prevent treaty benefits being available in "inappropriate circumstances", in particular where a person either seeks to use the provisions of a tax treaty to circumvent the limitations of the treaty itself, or attempts to use a treaty to avoid domestic law requirements.

The following two approaches to Treaty shopping have been adopted by the OECD:

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\(^{116}\) These circumstances might include where a Finance Party is located in an emerging markets jurisdiction in which it is unclear whether a Model I IGA will be signed, or where despite operating from a Model I IGA jurisdiction an Agent is a Qualified Intermediary for the purposes of FATCA.

a "limitation on benefit" (LOB) rule, similar to that included in US tax treaties and aimed at identifying cases where income is passed to third countries; and

a purpose test, similar to the rule included in the UK’s recent tax treaties.

The practical outcome of this is that where the BEPS recommendations are incorporated into a tax treaty, taxpayers will need to satisfy either or both of the LOB and the purpose test (depending on which approach is selected by the OECD member in question).118

Finally, in addition to Action 6, a further new proposal has also been made to prevent entities from benefiting from a "special tax regime" from treaty relief. The "special tax regime" concept specifically targets regimes that result in a low effective tax rate, with some limited safe harbours for entities such as pension funds, charities and regulated funds.

Who will it impact?

Neither the BEPS Action Plan nor the various deliverables have the force of law in their own right. However, it is expected that a large number of countries will begin implementing the changes once the deliverables have been finalised. As a result, most corporate groups and financial institutions will be affected, as will funds and SPVs that rely on tax treaties to receive income from their debt and equity investments free from withholding tax.

How will it impact the syndicated loan market?

Action 6 is causing the market particular concern on the basis that it may inadvertently deny Treaty benefits to certain types of debt fund (including CLOs, securitisations and other SPVs established to advance or acquire loans to individual or corporate borrowers).

Although debt funds are not tax motivated transactions, some tax planning is required to ensure that the transactions are economically viable, as interest rates on loans are typically set on the basis that there will be no withholding tax. The debt fund itself or a subsidiary will therefore be an SPV located in a jurisdiction which has tax treaties with expected borrower jurisdictions to ensure that interest on loans that are acquired can be paid free of any withholding tax. For example, an SPV lending to European borrowers will generally be established in the UK, Ireland, Luxembourg or the Netherlands.

Whilst the purpose test should not be difficult to satisfy (given that debt funds are entirely commercial arrangements) the proposed LOB rule is much more problematic. This is because the LOB rule has the overall effect of preventing treaty relief for most entities, unless they can show that their ultimate beneficial owners are themselves entitled to equivalent relief. Many debt funds will

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118 Under current proposals it should be noted that where a treaty includes the purpose test, it can include a "simplified LOB" instead of the original LOB. The differences are outside the scope of this guide on the basis that the LOB will impact the syndicated loan market regardless of the approach chosen.
simply be unable to demonstrate this, because it is generally either impractical or impossible for them to identify their ultimate investors.\footnote{119}

Although the OECD has responded to market concerns with a number of measures to enable regulated funds (CIV funds) to qualify under the LOB, this does not extend to other funds and SPVs (non-CIVs) such as CLOs. The industry had been hoping that the revised Action 6 draft would include new exemptions or other provisions for non-CIVs but unfortunately this has not occurred.

As debt funds are entirely commercial vehicles, the LMA has argued that they are clearly not "abusive" and that it is entirely appropriate that they should be granted Treaty benefits. The LMA has also stressed the importance of any final proposals around Action 6 addressing the position of debt funds, and preserving their treaty eligibility.

Finally, the LMA has also lobbied against the more recent "special tax regime" proposals, highlighting the special tax rules that are currently in place in many jurisdictions for securitisations. These rules ensure that the SPVs used in such financings are subject to simplified tax rules and bear no, or a nominal amount of tax. This means that the underlying corporate is able to raise debt financing on a cost-effective basis. As this proposal is drafted, SPVs falling to be taxed within the above special rules would be caught. In addition, other debt funds that are taxed under rules which provide for a preferential effective rate of tax would also be caught.

The LMA has stressed that, at the very least, consideration should be given to extending the exception included within the proposed regime definition so that it extends to securitisation companies and other debt funds.

The big question which remains unanswered at present is which countries will adopt which of the approaches set out above in their tax treaties. Indeed, even where two countries agree that a LOB should be included, they may differ as to whether they consider the original LOB or a "simplified LOB" to be appropriate.\footnote{120} Where countries disagree on approach, it is unclear how tax treaties will be amended and it may mean that this is a bar to an efficient implementation of any changes.

\footnote{119} It should be noted that under the proposed approach, treaty relief is not automatically permitted to the extent the ultimate beneficiaries are entitled to treaty relief – instead it denies treaty relief unless entitles can actually demonstrate that their beneficiaries are entitled to such relief.

\footnote{120} Please note that there are some indications that, in fact, the LOB is favoured by only a handful of jurisdictions (including the US).
Section 5

ASSESSING THE CUMULATIVE IMPACT

One of the LMA’s key concerns in relation to the abundance of regulation currently flooding the syndicated loan market is the failure by regulators to carry out a cumulative assessment of the varying proposals, by which they would assess their combined impact on the industry as a whole.

Whilst it is not the purpose of this guide to undertake a detailed cost analysis, it is not difficult to see some worrying trends emerging, simply by looking at those regulations discussed above, as part of a wider "package".

Some of these trends are likely to include:

1. Reduced product offering for borrowers and impact on lending structures

The following regulations are likely to affect the above:

- **CRD IV.** This regulation has perhaps the greatest influence on a bank’s product offering. For example:
  
  - The increased regulatory capital charge imposed on financial institutions means that impacted lenders will be less likely to lend to these types of borrower generally, thus reducing the number of products offered to such entities, particularly on an unsecured basis. It is also likely to result in increased reluctance on the part of any bank to take on a fronting role, which will impact trade finance products in particular.

  - The practical effect of the leverage ratio on netting will affect loan assets linked to designated pre-funding or cash backing (often used in trade finance structures through the offering of bonds and guarantees) as well as a borrower’s general ability to access overdraft facilities which allow them to combine debit/credit balances. The number of trade finance and basic cash management products could therefore decrease or become more expensive.

  - The LCR requirements may mean that banks are less likely to offer liquidity facilities to certain types of customer, except perhaps at a premium.

  - Given that under the NSFR, many loan facilities with maturities of more than one year will need to be funded by stable funding, there is a chance that this could bring about an increase in banks looking to provide loan facilities of shorter duration, which may be called at any time. In general, committed loan facilities with longer tenors are likely to be less attractive for banks.

- **CRD IV, the Banking Reform Act, the EU structural separation proposals, EU Retention Requirements (and additional proposed securitisation regulation), MiFID 2, CRA III, BEPS and Solvency II.** From the perspective of lender access to different types of loan investment, all of these regulations may bring about a reduction in the desire (or the ability) to invest in loan securitisations, CLOs and structured loan products generally, whether due to investment prohibitions/disincentives, obligations on participants to retain an economic interest, onerous
transparency and disclosure requirements on the part of those offering the investments or, in the case of insurers and reinsurers, the application of capital charges on those who choose to invest.

Overall, unless certain regulations are reconsidered, it is possible that lenders will be cautious about offering, or investing in, certain loan products in the future. Although a cause for concern in general, perhaps the most worrying implications are for the trade finance market. Any restrictions imposed on these products by regulators would appear to be completely counter-intuitive, for three reasons: 1) these products, historically, have had very low default rates and good levels of recovery; 2) governments are seeking to stimulate trade in an effort to revive the global economy and it is these types of products which are necessary to achieve this objective; and 3) the use of relatively straightforward trade products such as export confirmed letters of credit are one of the more traditional products sought by SME borrowers looking to grow their businesses internationally. These are the very businesses to which governments are currently hoping to stimulate lending.

2. Increase in loan due diligence and facility management time

The following regulations are likely to affect the above:

- **CRD IV.** Under the capital requirements, arrangers and lenders will need to assess which borrowers constitute "financial institutions" for the purposes of calculating any risk premium (and, as illustrated in Section One, this is not a simple process). Lack of clarity surrounding definitions could increase the administrative burden further. In addition, under the LCR proposals, some lenders may consider it necessary to monitor facilities more closely to ensure that funds which are advanced and designated as "credit" facilities are not used by borrowers as "liquidity" facilities instead.

- **AIFMD.** Fund managers and depositaries will have to take increased interest in loan due diligence processes (both during and after negotiations are concluded) as well as the evidencing of title to loan assets, in order to ensure that they do not breach any of their obligations under this Directive.

- **FATCA.** Increased due diligence will be necessary in order to monitor the status of US and FFI borrowers, as well as other lenders in the syndicate. Although the need for this may be abated to some extent by the publication of the Model 1 IGA, it will still be necessary for many lenders to improve their operational requirements in order to ensure that reporting requirements may be met.

Overall, if the relevant regulatory proposals are implemented as envisaged, it is difficult to see how it will be possible to manage the loan process as quickly or as efficiently as has been the case in the past. The time taken to monitor and manage loans, whether prior to execution or during the life of the facility, is likely to go up exponentially, which will bring about an increase in operational costs, whether through the need to employ additional personnel, or implement more efficient automated processes. Given that this need will arise precisely at a time when resources are scarce, it remains to be seen how loan participants will manage the requirements.
3. **Funding difficulties for lenders**

The following regulations are likely to affect the above:

- **CRD IV.** Given that capital requirements introduce a premium on exposures to other financial institutions, that the LCR provisions generate a 100% liquidity requirement for facilities to certain financial institutions and that under the NSFR, the majority of loans to financial entities must be funded 100% by stable funding, there is a clear disincentive for banks to lend to each other, particularly if such lending is unsecured.

- **Banking Reform Act.** UK legislation seeks to prohibit ring-fenced banks from generating financial institution exposures, which could result in those banks being unable to lend to, for example, investment firms, even for general corporate purposes. More generally, it will discourage (or even prohibit) inter-bank lending between ring-fenced banks across the board and will also prevent them from undertaking any investments where they deal as principal. As a result, ring-fenced banks will not be able to directly invest in, for example, investment funds.

- **Solvency II.** Under this regulation, insurers and reinsurers will be discouraged from investing in both equity and long-term debt, which means that financial institutions may find it difficult to find ready lenders within the insurance industry willing to invest in their equity and long-dated bonds.

When combining the above factors with other proposed regulations such as potential regulation of the repo and secured funding markets and the existing difficulties which arise when attempting to use loans as collateral for central bank funding (all of which are outside the scope of this guide), fundamental questions arise as to exactly where, and at what cost, lenders are likely to obtain their funding in the future.

4. **Reduced liquidity:**

This is likely to come about automatically as a result of points one to three above. However, the following specific points should also be noted:

- **CRD IV.** Whilst capital requirements and the leverage ratio will disincentivise banks from offering trade finance products and loans to financial institutions, the LCR and NSFR proposals will also discourage the provision of liquidity facilities, as well as facilities to a wide variety of borrower types.

- **Solvency II.** Whilst insurers and reinsurers could become more active in certain sectors of the market, the requirements could also lead to less liquidity in others.

- **AIFMD.** Potential restrictions on the leverage levels of alternative investment funds could lead to a reduction in the amount of available liquidity to enable such lenders to invest in loans.

- **Shadow banking and CRA III.** Prohibitions imposed on certain non-bank lenders could lead to a reduction in available liquidity from this market.

- **EU Retention Requirements.** The implementation of risk retention requirements has impacted CLO issuance. Consequently, resulting in a reduction of liquidity.
• **MiFID 2.** Increased transparency and disclosure requirements could mean that fewer lenders have the capabilities to offer structured loan products in the future. This could result in reduced liquidity available in relation to the underlying loan assets.

• **FATCA.** FATCA could lead to a reduction in liquidity from lenders based in jurisdictions which do not have a Model IGA in place.

• **BEPS.** If the BEPS proposals were to be implemented in their current form, they could prevent a significant element of the loan market (i.e. debt funds) from engaging in further lending, as well as potentially triggering a widespread disinvestment from their existing positions.

Overall, the potential reduction in available liquidity to the syndicated loan market is concerning, particularly because it is difficult to see how economic recovery is to be achieved unless funds become more readily available.

5. **Increased costs of borrowing**

Whilst an increase in borrowing costs is often an inevitable conclusion when liquidity is reduced (except perhaps for the most highly rated borrowers) the following points should be emphasised:

• **CRD IV.** The risk premiums imposed on financial institutions under the capital requirements, the netting implications of the leverage ratio (particularly on trade finance products), the 100% liquidity requirements for certain loan products under the LCR and the requirement to obtain stable funding for the majority of loan activities under the NSFR are likely to mean that affected borrowers could be forced to pay premiums to obtain these products in the future.

• **Solvency II.** Although investment opportunities may be created for certain types of loan facilities on the basis that there is increased interest from insurers and reinsurers to invest in them for the purposes of their capital requirements, loans with longer maturities and loan securitisations are likely to be less attractive and may therefore become more expensive to obtain.

• **Banking Reform Act and EU structural separation proposals.** Unless UK and European legislation relating to the ring-fencing of certain banking services becomes more closely aligned, the increased operational costs likely to arise as a result of complying with both sets of requirements could impact the cost of borrowing going forward. This is especially likely given that, if different services are offered by different legal entities within a banking group, it will be difficult for banks to offer a complete "package" of banking products and services – the benefit of which, historically, has meant lower overall costs for the customer.

In addition to the above, borrowing costs are likely to increase indirectly simply as a result of the need for more detailed due diligence and loan monitoring, which in itself will generate substantial operational and administrative costs. It is likely that lenders will attempt to recoup at least some of these costs from their borrowers.
CONCLUSION

The regulations discussed in this guide, along with their potential cumulative impact, suggest that much greater debate and analysis is required on what degree of regulation is really necessary. In order for regulation to be truly effective, it must be accepted that there is simply no such thing as a risk-free environment and that regulation has the ability to do harm, as well as good.

Regulators therefore need to consider the following points:

- **Undertake a thorough risk assessment which looks at the cumulative impact of regulation on the industry, across all financial markets.** The cumulative impact of the interaction of different regulatory measures is often overlooked, even on an intra-European level. Unless a detailed impact assessment is carried out across the financial markets, there is a real risk of significant unintended consequences – including the creation of perverse incentives within the regulatory system as a whole. Efforts should therefore be directed away from individual policy silos and towards the construction of a comprehensive assessment of the totality of these proposals on the global economy and its financial services industry. Only once this assessment has been carried out, should further appropriate and targeted regulation be considered for specific banking activities.

- **Implement regulation with the benefit of global consensus to avoid regulatory arbitrage.** The composite effect of national and EU regulation must be assessed in the context of global legislation, including both significant national legislation of non-EMEA countries (particularly the US) and supranational initiatives (such as the G20 and the FSB). This is a vital exercise which, if ignored, could put certain jurisdictions at a competitive disadvantage and lead to borrowers within those jurisdictions being unfairly affected.

- **Recognise that financial institutions must take on some responsibility for their own regulation.** Whilst the mistakes made by financial institutions during the financial crisis cannot be denied, and the need to curb excessive risk taking should be accepted, responsibility for basic investment decisions must ultimately rest with the institutions themselves and this is not something which can, or indeed should, be governed by extensive legislation. In many ways, the financial services sector has already made substantial progress since the start of the financial crisis to strengthen its lending criteria, legal due diligence and credit/risk assessment processes and it is this, along with balanced and considered regulation, which will ultimately establish the foundations for a safer financial system.

- **Consider education, in addition to regulation.** As has already been discussed, too much regulation is likely to have the ultimate outcome of stifling economic recovery. Regulators should therefore accept that, in certain circumstances, a better regulatory proposal would be for regulatory authorities to take on an educational role. This could be achieved simply by explaining the risks associated with certain products and to offer greater access to dedicated training in order to enable businesses and other consumers to make informed investment decisions.

- **Ensure that banks are not prevented from offering basic loan products which are vital for small and growing businesses.** Although it may theoretically be possible for non-banks to lend to SME
and micro businesses, in practice, non-bank finance providers, particularly institutional asset managers, are not set up to finance these kinds of borrower and will therefore realistically only play a part in financing larger companies. In addition, a fundamental requirement of smaller businesses is working capital finance, as well as ancillary facilities such as letters of credit and overdrafts. These types of offering are typically not attractive to institutional lenders, firstly because, unlike banks, who redeploy deposits, asset managers have to source funding from institutional lenders and are therefore not in a position to offer these types of facilities. As a result, that they are better suited to providing term funding which is fully drawn from the outset. This suggests that it would be difficult to disintermediate the banks entirely and therefore, banks will have to continue to play a key role in the provision of working capital finance for the foreseeable future. If banks are discouraged by regulation from offering certain types of product, it seems unlikely that other lenders will be available to fill the gap.

- **Recognise the importance of the non-banks.** Much has been publicised recently about the need to stimulate the credit markets and, with banks continuing to shrink and delever, non-banks are likely to become a much more important source of credit in future. If their activities become unduly constrained, or the costs of compliance become excessive, these vehicles will have neither the resources nor the incentive to invest. Bank disintermediation is seen to a greater degree in the US than in Europe, particularly lending to US middle market. This issuance is facilitated by loan mutual funds (channelling retail capital to corporates), CLOs and listed companies known as Business Development Companies. Therefore, in order to generate additional liquidity to the European financial markets, appropriate non-bank vehicles, with appropriately tailored regulation, should be considered as potential viable options.

As a final overarching point, legislators and regulators must recognise that, ultimately, measures must be taken to encourage growth, not curtail it, especially given that the global economic situation remains fragile. Whilst targeted and proportionate regulation to guard against excessive risk in the financial system is welcome, this must ultimately be balanced against the need to bring about a healthy economic recovery.
### GLOSSARY

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>BaFin</td>
<td>Bundesanstalt für Finanzdienstleistungsaufsicht; the German supervisory authority.</td>
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<tr>
<td>BCBS</td>
<td>The Basel Committee on Banking Supervision. Provides a forum for cooperation on banking supervisory matters, with the aim of improving the quality of banking supervision worldwide.</td>
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<tr>
<td>Capital Requirement</td>
<td>A capital requirement acts as a buffer against future, unknown losses and is a measure of the difference between the value of an institution's assets and its liabilities. By contrast, expected losses are covered by specific reserves or provisions. The qualifying capital of banks consists of equity and other types of financial instrument that have the ability to become quickly available to support a bank during times of crisis. Under Basel III, a minimum amount of capital is required to protect against credit risk, market risk and operational risk.</td>
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<tr>
<td>CCR</td>
<td>Counterparty credit risk. The risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.</td>
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<td>CEIOPS</td>
<td>The Committee of European Insurance and Occupational Pensions Supervisors (now EIOPA – see below).</td>
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<tr>
<td>CIU</td>
<td>Collective investment undertaking. A vehicle which constitutes either an AIF or a UCIT.</td>
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<td>CLO</td>
<td>Collateralised Loan Obligations. A special purpose vehicle which, via a CLO manager, purchases a portfolio of loans. The risk in relation to that loan portfolio is then sold on to lenders in the capital markets through CLO notes, which are divided into risk &quot;slices&quot; or tranches.</td>
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<tr>
<td>Commission</td>
<td>The European Commission. The central administrative and policy making body of the EU which initiates most legislation.</td>
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<tr>
<td>CRD</td>
<td>Depending on the context used, CRD may refer to either the current Capital Requirements Directives (2006/48/ and 2006/49) or the new &quot;CRD IV&quot; proposals, which consist of a new directive (the Capital Requirements Directive) and regulation (the Capital Requirements Regulation (CRR)).</td>
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<tr>
<td>CRM</td>
<td>Credit risk mitigation. A technique used by an institution to reduce the credit risk (and corresponding risk weighting) associated with an exposure or exposures which that institution continues to hold (Article 4(57), CRR). CRM may take the form of either funded credit protection such as collateral or netting (Article 4(58), CRR) or unfunded credit protection such as a guarantee (Article 4(59), CRR). The funding may be provided either by the entity on whose behalf the exposure has been incurred, by a guarantor or via a third party charge. In order to be eligible, CRM must meet the requirements of the CRR (Articles 195-217) and these differ depending on whether the Standardised or IRB Approach is being used. For example, immovable property is only eligible under the IRB Approach.</td>
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<td>Term</td>
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<tr>
<td>EBA</td>
<td>European Banking Authority.</td>
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<td>ECON</td>
<td>Economic and Monetary Affairs Committee. A committee forming part of the European Parliament which deals with, amongst other things, economic and monetary policies of the EU.</td>
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<td>EAD</td>
<td>Exposure at Default. An estimation of the extent to which a bank may be exposed to a counterparty at the time of that counterparty's default. For example, in the case of a term loan, EAD would be equal to the current amount outstanding.</td>
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<tr>
<td>EEA</td>
<td>The European Economic Area. Established to enable certain European countries without official EU membership to participate in the EU internal market. In exchange, the relevant countries agree to implement relevant EU legislation.</td>
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<tr>
<td>EIOPA</td>
<td>The European Insurance and Occupational Pensions Authority (formerly CEIOPS). One of the three European Supervisory Authorities, forming part of the European System of Financial Supervision, along with the European Systemic Risk Board. EIOPA’s core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries.</td>
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<tr>
<td>ESMA</td>
<td>The European Securities and Markets Authority. One of the three European Supervisory Authorities (for further information, see EIOPA above). ESMA's key objective is to ensure the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.</td>
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<tr>
<td>EU</td>
<td>The European Union. The name given to the formal association of 28 European countries forming part of that union.</td>
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<tr>
<td>European Council</td>
<td>The European Council, comprising appropriate government ministers from each Member State, is the principal decision-making body within the EU.</td>
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<tr>
<td>European Parliament</td>
<td>The European Parliament consists of democratically elected MEPs from each Member State and shares the power to legislate with the European Council.</td>
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<td>FATCA</td>
<td>The Foreign Account Tax Compliance Act.</td>
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<td>FCA</td>
<td>Financial Conduct Authority.</td>
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<tr>
<td>FSB</td>
<td>Financial Stability Board. Established to coordinate the work of national financial authorities and international standard setting bodies at an international level and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.</td>
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<td>Acronym</td>
<td>Definition</td>
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<tr>
<td>G20</td>
<td>Group of 20. A group of 20 major economic nations from around the world, set up to cooperate and consult on matters relating to international financial stability and to strengthen the global economy.</td>
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<td>HQLA</td>
<td>High Quality Liquid Assets.</td>
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<tr>
<td>ICB</td>
<td>Independent Commission on Banking. Established to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. Recommendations were made on 12 September 2011 in the form of the Vicker’s Report.</td>
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<tr>
<td>IGA</td>
<td>A model intergovernmental agreement produced in response to the FATCA legislation, which has been entered into by various countries with the US (including France, Germany, Italy, Spain and the United Kingdom). The aim of the IGA is to simplify FATCA compliance for financial institutions in those jurisdictions by enabling exchange of FATCA required information between governments. See Section 4 on FATCA for further details.</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions.</td>
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<td>IRB</td>
<td>An internally assessed approached, as ascertained by the use of internal models.</td>
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<tr>
<td>IRS</td>
<td>Internal Revenue Service. The United States government agency responsible for tax collection and tax law enforcement.</td>
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<tr>
<td>LCR</td>
<td>Liquidity Coverage Ratio. One of the prudential requirements under Basel III.</td>
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<td>Level 2</td>
<td>Level 2 legislation consists of implementing measures (prepared by the Commission) which are intended to supplement the underlying Level 1 framework legislation.</td>
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<tr>
<td>LGD</td>
<td>Loss Given Default. The percentage of an asset that is lost when a borrower defaults.</td>
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<tr>
<td>MiFID 2</td>
<td>Proposals to revise the Markets in Financial Instruments Directive (see MiFID above) consisting of a directive and a separate regulation.</td>
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<td>MMF</td>
<td>Money market funds.</td>
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<td>NBFI</td>
<td>Non-bank financial institutions.</td>
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<tr>
<td>NSFR</td>
<td>Net Stable Funding Ratio. One of the prudential requirements under Basel III.</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development.</td>
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<td>OJ</td>
<td>The Official Journal.</td>
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<td>Acronym</td>
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<tr>
<td>PD</td>
<td>Probability of Default. The likelihood of a default over a particular time horizon. It provides an estimate of the likelihood that a borrower will be unable to meet its debt obligations.</td>
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<td>PRA</td>
<td>Prudential Regulation Authority.</td>
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<td>SFT</td>
<td>Securities financing transaction.</td>
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<td>SIV</td>
<td>Structured Investment Vehicle. An entity which funds itself via the issuance of short-term securities such as commercial paper, which then uses the proceeds of such issuance to invest in higher yielding assets for a longer term, such as mortgage-backed securities (MBS). Profits are obtained on the spreads between the income received from the high-yield assets and the short-term securities issued by the SIV.</td>
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<tr>
<td>SPV</td>
<td>Special Purpose Vehicle. An entity set up for a specific and limited purpose, usually for an acquisition, a financing or as part of a securitisation.</td>
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<tr>
<td>SSPE</td>
<td>Securitisation Special Purpose Entity. A type of SPV used to securitise loans or other receivables.</td>
</tr>
<tr>
<td>Standardised Approach</td>
<td>A standard regulatory approach, as prescribed by regulation.</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investments in Transferable Securities. A type of common fund, unit trust or investment company whose object is collective investment in a wide range of financial instruments.</td>
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</table>
The numerous regulatory and legislative regimes which are currently before us, are often described as an ‘alphabet soup’. This booklet (updated from the July 2013 edition) is intended to help you digest them. Spanning regulatory measures including AIFMD, Solvency II, Basel III and CRD IV, amongst others, this booklet may not increase your appetite for regulation, but it will certainly improve your understanding of the menu.