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The Head of Risk Management Division
Bank of England
Threadneedle Street
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12th May 2010

Dear Sirs,

Re: A Consultative Paper by the Bank of England (BoE) – Extending eligible collateral in the Discount Window Facility (DWF) and information transparency for asset-backed securitisations

The Consultation Paper proposes, *inter alia*, that the eligibility criteria for collateral for drawings under the DWF be revised so that portfolios of loans which meet certain documentation and credit criteria may be used as DWF Collateral. We are writing to provide our input into the consultation, which we welcome as a significant initiative in improving liquidity and reducing risk in the financial system.

The LMA is the trade body for the syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity and efficiency in both the primary and secondary loan markets by promoting funding depth and transparency, as well as by developing standard forms of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at 420 across Europe 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 syndicated loan market in Europe vis à vis lenders, borrowers, regulators and other interested parties.

This response does not consider part III of the Consultation Paper, which deals with proposals for enhanced disclosure requirements in relation to asset-backed securities used as DWF Collateral.

In responding to your paper we have consulted with our members and with the lawyers who assisted with the drafting of our loan documentation.

We reply to your questions as follows.

Paragraph 10

(i) In the view of counterparties, is there likely to be demand for delivering loans as collateral in the DWF?

The initial feedback from our members is that there would be demand for including loans as collateral in the DWF, particularly as a source of liquidity in stressed market conditions. However usage would be driven by a function of the costs of complying with the data requirements to meet the eligibility criteria, the cost of drawings and the availability of other facilities for securing liquidity, such as securitisations.

(ii) What would be the main obstacles/challenges for participating counterparties?

The principal challenges arise in the areas of the methods of taking collateral, standardisation of documentation, set-off rights in insolvency, confidentiality obligations towards the borrower, agreeing the data/reporting requirements and the operation of the pre-positioning process, none of which we consider to be insurmountable issues.

iii) What would be the primary benefits over and above other collateral types?

The lack of complexity and relative transparency of the product, particularly with regards to credit and documentation risk, means that loans are a relatively attractive asset class. There should also be a cost saving for banks in not having to structure a transaction to raise liquidity. There is also a social dimension, which is alluded to in the paper, in that loans assist the private corporate sector. In making this form of lending more attractive to banks, it promotes the provision of liquidity at an important time in the economic cycle and widens the diversity of funding options in times of market stress.

(iv) Which types of loan portfolio would be the most straightforward to deliver in the short term and in the medium term?

The eligibility criteria largely determines the portfolio selection. Therefore in the short term, drawn corporate term loans would be the most straightforward to deliver. However, please see our suggestions, under paragraph 16(i), for including other loans into the portfolio in the medium term, as we believe it is important that the BoE is not seen to be favouring one part of the loan market over another.

Paragraph 14

(i) Do counterparties have any views on the proposed counterparty eligibility requirements?

The counterparty lending review appears appropriate.

(ii) Would any of the proposed criteria prevent widespread participation?

Clearly this will depend on the criteria set by the BoE, particularly in the areas of acceptable default and recovery rates, the standards of operations and risk management expected and the costs associated with meeting them.

Paragraph 16

(i) Do counterparties have any views on the proposed loan eligibility requirements?

It would be useful if you would clarify how you define a leveraged loan.

The leveraged loan market is an important part of the loan market. With a significant part structured as drawn term-loan facilities, it suits the loan eligibility criteria. We would suggest that, providing the minimum credit rating/scoring requirements are met, leveraged loans are also included. With a significant refinancing requirement coming up over the next 3 years we feel that including leveraged loans will assist liquidity in that market. If leveraged loans are not included and others are, this exclusion could negatively impact on available liquidity at a crucial time for refinancing large amounts of debt.

Another consideration is the inclusion of RCF facilities. Most mid-market/SME borrowers utilise RCF facilities and it would be helpful to include them among collateral as this will promote greater usage of the DWF. We think it would be beneficial if the drawn portions of such facilities, where for example the drawn period meets the minimum maturity requirement under the DWF, were considered eligible. We would be happy to discuss further with you how this might be achieved in a manner both acceptable to the BoE and practical for the market.

As proposed, the eligibility criteria excludes a large part of the less liquid loan collateral available and much of that which is eligible can be secured in other ways to raise liquidity and is therefore unlikely to be pre-positioned as required.

It should also be noted that many corporate loan facilities have multiple borrowers/subsidiaries and some of these may be domiciled in non-UK jurisdictions.

Regarding assignment and set-off rights please see our comments below.

(ii) Would counterparties comment on the currency and minimum/maximum maturity criteria for individual loans accepted as collateral?

The criteria appear reasonable, although it would be preferable if all major currencies are accepted.

(iii) The Bank is minded to set the minimum rating requirement at BB- (or its internal equivalent) for corporate loans but seeks views on the potential impact of such a requirement.

We think this is an acceptable short term requirement. However, the level of haircut ranging from 35% to 60% would appear to be high. We also believe that the lack of transparency and certainty in calculating haircuts which under paragraph 7 is 'discretionary' may restrict usage.

Further, consideration could be given to linking the concentration percentages, which we also feel are low, and/or haircut to rating, so that better-rated credits can form a higher concentration and/or have a lower haircut. Similarly this methodology could be extended, in the medium term, to include lower rated loans down to say B, providing haircuts and concentration levels are adjusted to reflect the increased risk. This would facilitate usage by increasing the quantum of eligible loans.

(iv) Would any of the proposed criteria prevent widespread participation?

Subject to our observations above we do not believe they would.

Paragraph 22

(i) Do counterparties see any particular issues with the Bank's legal requirements for loan delivery and loan documentation?

It is envisaged that the eligibility criteria for corporate loan portfolios would require loan agreement documentation in the LMA standard form for investment-grade corporates or a counterparty's own form of loan agreements provided the terms are at least equivalent to the LMA standard.

This is, of course, helpful. However, it needs to be considered that the LMA Agreement is not a standard form. It is, rather, a recommended form that can be, and often is, heavily negotiated and which contains incomplete provisions (for example the Events of Default relating to non-payment or other breach of the agreement do not specify a grace period), or provisions and definitions which are blank (for example clause 21[1](*Financial Covenants*)). It is also common for further representations, covenants and Events of Default to be added to the LMA Agreement, depending on the transaction.

In this, for example by comparison, it differs from the ISDA Master Agreement, GMRA or GMSLA, which do not contain any blanks and include generally accepted grace periods and representations, covenants and events of default which are not normally modified or extended.

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[1] All clause references are to the LMA Recommended form of Multi-currency Term and Revolving Facilities Agreement dated April 2009.

It would, therefore, be useful if you could clarify what you mean by "the [LMA's] standard form for investment-grade corporates" and what level of amendment is acceptable before you will no longer consider an agreement to be in the LMA's standard form.

Once the boundaries to the negotiation of substantive matters such as grace periods, financial covenants, material adverse change etc. is established, it will become easier to define other documents as at least equivalent to the LMA Agreement.

It should also be considered that banks often do not use standard forms, but instead use the standard form of the law firm drafting the relevant loan agreement amended to include the documentation requirements of that particular bank. However, most of these forms are based on the LMA recommended form.

(ii) Do counterparties see any difficulties with the methods of transferring loans outlined above?

See below.

(iii) The Bank would welcome comment on any constraints in current loan documentation or counterparty funding documentation related to the transfer of loans to the Bank as collateral (including the ability to declare a trust) or giving security over the loans.

In order for a loan to be Eligible Loan Collateral, it must be "Freely assignable by the [lender] (or the borrower's consent cannot be unreasonably withheld or delayed and is deemed given within a short period of time"). The LMA Agreement includes a provision which complies with this at clause 24.2(b). This clause provides that the consent of the borrower is deemed to have been given if no express refusal is received within 5 Business Days of consent to a transfer or assignment being requested.

An additional point to note about the assignability provision of the LMA Agreement is that clause 24.1 states that the person to which an Existing Lender assigns or transfers its rights should be a "another bank or financial institution or... a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets." While this does not relate directly to the proposed assignability requirement it may cause problems with any equitable assignment of the loan to the BoE or declaration of trust over the loan in favour of the BoE. A declaration of trust is equivalent to a transfer of beneficial ownership so it will fall within this provision, if it is permitted at all by the LMA Agreement as currently drafted. This is because it may be possible to argue that the only alienations of the sort expressly set out in clause 24.1 of the LMA Agreement are permitted and so declarations of trust and the creation of charges, not being listed, are not permitted.

Depending on the outcome of the consultation process it may be worth considering changing the drafting of clause 24.1 to permit declarations of trust over the loans (the granting of charges will be permitted where clause 24.8 see below is used in the loan agreement).

In the case of an equitable assignment or transfer of beneficial ownership by declaration of trust it may be open to the borrower to argue that the BoE, as a central bank, does not comply with these criteria, because the term "another bank or financial institution" in clause 24.1 of the LMA Agreement should be interpreted to mean "another bank or financial institution of a similar type to the existing lenders (i.e. a retail or investment, but not central, bank)". A borrower may also attempt to argue that the language "established for the purpose of making, purchasing or investing in loans, securities or other financial assets" applies to all the entity types in the list and not just to "trust, fund or other entity". While this is probably not the correct interpretation of the clause it may be helpful if we look to modify it slightly to make this clearer.

Where the optional clause 24.8 of the LMA Agreement has been included in a loan agreement (see below) arguments about this point may become less relevant. However, even where clause 24.8 is included there still remains a residual risk that, because it is unclear what terms any equitable assignment or declaration of trust will need to be on, it could fall within clause 24.1 rather than 24.8. The Consultation Paper does not anywhere state that the assignment of the loan to, or transfer of beneficial ownership by declaration of trust in favour of, the BoE is by way of security and so subject to an equity of redemption. If these assignments or transfers are absolute and the BoE is intending to take full beneficial ownership of Eligible Loan Collateral without an equity of redemption, but with an obligation to redeliver equivalent loan interests once all obligations have been discharged and to pay manufactured interest payments to the lender, in a similar way to collateral using securities is structured, then the assignment is more likely to fall within 24.1.

We would ask the BoE to clarify your intentions in relation to this, since an absolute assignment or transfer of beneficial title, as opposed to one which is affected by way of security, may also have tax consequences.

Although it is not expressly mentioned in the Consultation Paper it is implicit that to be Eligible Loan Collateral a loan must be capable of being used as collateral in favour of the BoE. The LMA Agreement includes an optional clause 24.8 which states:

"In addition to the other rights provided to Lenders under this Clause 24, each Lender may without consulting with or obtaining consent from any Obligor, at any time charge, assign or otherwise create Security in or over (whether by way of collateral or otherwise) all or any of its rights under any Finance Document to secure obligations of that Lender including, without limitation:

(a) any charge, assignment or other Security to secure obligations to a federal reserve or central bank; and

(b) in the case of any Lender which is a fund, any charge, assignment or other Security granted to any holders (or trustee or representatives of holders) of obligations owed, or securities issued, by that Lender as security for those obligations or securities,

except that no such charge, assignment or Security shall:

(i) release a Lender from any of its obligations under the Finance Documents or substitute the beneficiary of the relevant charge, assignment or Security for the Lender as a party to any of the Finance Documents; or

(ii) require any payments to be made by an Obligor other than or in excess of, or grant to any person any more extensive rights than, those required to be made or granted to the relevant Lender under the Finance Documents."

This clearly permits the creation of charges over the loans, as required by one of the proposed methods of using loans as collateral. However, it is less clear that it would permit an equitable assignment or transfer of beneficial ownership by declaration of trust if, as discussed in paragraph (b) above, that assignment or transfer of beneficial ownership by declaration of trust is not by way of security. Although clause 24.8 does refer to the lender being able to "charge, assign or otherwise create Security in or over all or any of its rights" the use of the words "or otherwise create Security" seems to imply that everything in that list must be Security of some type as defined in the LMA Agreement[2]. Therefore, if you could clarify the nature of the security to be given and confirm whether you want an absolute assignment of beneficial ownership or transfer of beneficial ownership by declaration of trust, rather than an assignment or declaration of trust by way of security, clause 24.8 could be revised to make it clear that such assignments and declarations of trust are permitted without consent.

(iv) The Bank would welcome comment on any other legal or related issues in relation to the Bank accepting loans as collateral.

To be Eligible Loan Collateral, a loan must include a "Restriction against borrower set-off rights". This is expanded on in paragraph 22 of the Consultation Paper which says that "loans

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[2] Security means "a mortgage, charge, pledge, lien or other security interest securing any obligation of any person or any other agreement or arrangement having a similar effect".

would not be eligible... if the obligor has material claims on the [lender] that it may, *in insolvency*, set-off against amounts due under the loan [Emphasis added]."

The LMA Agreement includes, at clause 29.6, a contractual restriction on set-off by the Obligors which states that "All payments to be made by an Obligor under the Finance Documents shall be calculated and be made without (and free and clear of any deduction for) set-off or counterclaim."

While this appears to comply with the proposed BoE requirements there is a potential problem with this requirement in cases of insolvency. Under English law it is not possible to contract out of mandatory set-off on insolvency under rule 2.85 of the Insolvency Rules 1986[3]. Therefore, if a borrower or a lender becomes insolvent, clause 29.6 of the LMA Agreement will not be effective and a liquidator will be obliged to set-off their mutual credits and debits in accordance with rule 2.85. This means that, unless the BoE position set out in the Consultation Paper is modified, it will not be possible for banks to use loans to companies for whom they act as clearing bank, or otherwise have significant accounts of that company maintained with them, as Eligible Loan Collateral.

There may be scope to avoid this problem if the loan is assigned to the BoE, rather than charged in its favour, since there is authority for the proposition that rule 2.85 set-off "in general does not apply where the debt due to the bankrupt has been assigned by him before the bankruptcy order."[4] However, this only applies in relation to a winding-up of the lender. The position if the borrower were to be wound-up or the borrower and the lender were being wound up at the same time is less clear[5].

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[3] SI 1986/1925 as amended.

[4] Halsbury's Laws Volume 3(2) (*Bankruptcy and Individual Insolvency*) para 553. Although the specific quote relates to bankruptcy, it is stated at paragraph 63 of Halsbury's Volume 13 (*Choses in Action*) that the principle also applies on winding-up of a company.

[5] Very broadly the borrower is entitled to exercise rights of set-off which arose any time prior to it receiving notice of the assignment of the debt in accordance with the principle that an assignor cannot give better title than that it has itself. See Halsbury's Volume 13 (*Choses in Action*) para 63. Most of the case law on this issue is from the 19^{th} century and it is not clear if a modern "payments to be made without set-off or counterclaim" clause such as 29.6 of the LMA Agreement means that no rights of set-off can be said to have accrued at the time of the assignment or if it is merely a contractual agreement not to assert them (if the latter is correct there may be an argument that amounts may be set-off on insolvency under rule 2.85, although this is probably not the better view).

Paragraph 27

(i) What are the views of counterparties on the pre-positioning of loan pools with the Bank?

This would appear the best way to ensure that drawing under the DWF, when required, can be affected in a timely manner. However, it may limit, subject to any clarification provided in response to our request below, the quality of the available portfolio to those less liquid assets which cannot be used to raise liquidity by other means, such as through a securitisation programme. Loans which have been so securitised will not be pre-positioned in normal market conditions where they can be used to raise liquidity from other sources, however in stressed conditions the option of using these assets to draw under the DWF could be considered. Given the pre-positioning process is close to that of a securitisation banks may wish to retain flexibility by either pre-positioning loans in securitised form or looking to utilise them only as eligible collateral under the DWF in stressed market conditions when other sources of funding are unavailable or more expensive for those assets. However, in the later case the lead time for pre-positioning is likely to be limited.

It would be helpful to understand whether pre-positioning precludes other funding sources being undertaken with the pre-positioned loans or whether providing they have been pre-positioned, the loans can be used as collateral for other sources of funding in normal market conditions and only as eligible collateral under the DWF in stressed market conditions, when other sources of liquidity are restricted. Certainly it would not be desirable for the loans to be subject to trust, equitable assignment or security interest without a drawing being made under the facility.

(ii) Would there be any constraints (eg operational, legal or other) which might make pre-positioning loans impractical?

This will depend on the outcome of discussions on the data and operational requirements and will also depend on the type of loans pre-positioned. In as much that the pre-positioning loans require a similar level of legal due diligence and pool audits to those in securitising the loans then the constraints should be minimal. However, where this is not the case then the establishing of the necessary operational functionality could present a constraint.

Paragraph 28

(i) Counterparties are asked to comment on any operational constraints on sharing information on loan portfolios with the Bank.

Whilst most information is in electronic format some may not be and the delivery of this information will need to be agreed.

(ii) Specifically, counterparties are asked to comment on any legal restrictions arising from sharing loan-level information with the Bank.

In order for the BoE to be able to assess whether or not it will accept a loan portfolio as Eligible Loan Collateral and to allow the BoE to continue to monitor those loans after they have been so accepted it must be possible for the lender to provide certain information to the BoE without breaching the relevant loan agreements.

The LMA Agreement includes a confidentiality undertaking at clause 36 which imposes a duty of confidence on the Finance Parties in relation to any information they receive from the borrower group under the Finance Documents or in connection with becoming a Finance Party under the Finance Documents unless, broadly, such information is in the public domain or agreed not to be confidential.

Clause 36.2(b)(i) of the LMA Agreement contains an exemption from the confidentiality undertaking in respect of any disclosure of such Confidential Information as that Finance Party consider appropriate "to any person to (or through) whom it assigns or transfers (or may potentially assign or transfer) all or any of its rights and/or obligations under one or more Finance Documents and to any of that person's Affiliates, Related Funds, Representatives and professional advisers" provided that the recipient of the Confidential Information has entered into a Confidentiality Undertaking. The BoE will need to clarify that it would be willing to enter into such Confidentiality Undertakings.

The LMA Agreement also includes an optional clause 36.2(b)(vi) which is designed to be used in conjunction with the optional clause 24.8 (see above) and provides that lender may disclose Confidential Information to any person "to whom or for whose benefit that Finance Party charges, assigns or otherwise creates Security (or may do so) pursuant to Clause 24.8 (*Security over Lenders' rights*)". Where this clause and clause 24.8 are used, and provided that the loan is used as security in a way that falls within clause 24.8, it will permit a lender to make the required disclosures to the BoE. Clause 36.2(b)(C) of the LMA Agreement requires the lender to inform any person to whom Confidential Information is disclosed under 36.2(b)(vi) that such information is confidential and may be price sensitive.

Paragraph 29

(i) The Bank seeks comment on the potential criteria requiring a minimum individual loan rating (either from a public or internal source).

One of the strengths of the loan product is that banks usually undertake their own independent credit review before lending, as a result of which they will have generated their own internal credit risk score for the loan. It will be necessary to ensure that banks' internal rating methodologies are consistent. In the UK we assume the FSA would ratify any internal credit rating methodology.

An advantage of using internal ratings is that it will reduce the cost relative to a securitisation in that an external rating will not be required.

(ii) Would some loan types be more impacted than others?

If the requirement was to have a public rating then this would exclude loans to the mid-cap/SME market, which are not usually rated. However, given our comment above we do not see any undue differential impact on one class of loan over another.

(iii) What would be the potential constraints on translating/mapping credit risk model outputs to a public rating agency scale?

Banks may employ different methodologies for internal credit ratings. These would need to be aligned as noted above.

Paragraph 35

(i) Counterparties are asked to outline any operational constraints that may make the delivery of loans in the DWF unfeasible.

We do not believe there are, however banks will have different levels of system capability and this will determine their individual ability to meet the required data requirements for the delivery of loans.

(ii) The Bank would be interested to know from counterparties how long they envisage systems development would take in order to meet the proposed requirements for provision of data to the Bank and demarcation of loans provided to the Bank.

We do not have a common view, as it will depend on each bank's IT development budget and their priorities.

(iii) Counterparties are asked to comment on their ability to provide updated information on both pre-positioned loan portfolios and loan portfolios provided as collateral on a weekly basis.

This will depend on resources allocated to the task which will largely be a function of the liquidity benefit and cost of having access to the DWF.

We would suggest that data updates are aligned to commercial reporting periods and that maybe weekly reporting is unnecessarily onerous.

(iv) Will banks seek to pre-position as required?

We believe that they will subject to our reservation above under paragraph 27 (i).

We will continue to engage with our members so that we can provide further input to you as matters arise.

As you can see from the above there are several areas which we would welcome the opportunity of discussing further with you as you develop your proposals. We would be pleased to meet again with you, to explore further the points which we have raised which require further clarification.

In the meantime, if I can be of any further assistance I can be contacted via email at clare.dawson@lma.eu.com or by telephone on 020 7006 2216. Alternatively my colleague Nicholas Voisey can be contacted by email nicholas.voisey@lma.eu.com or by telephone 020 7006 5364.

Yours sincerely

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