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Documentation Should Enable, Not Inhibit, Loan Market Liquidity

Addressing contractual barriers to enable effective bank portfolio management and risk distribution

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At a glance

- Banks need a range of credit risk transfer solutions to manage credit risk, concentrations and balance-sheet capacity.
- These products help lenders manage concentration risk, capital costs and lending capacity without selling the underlying loan or changing the nature of the lender-borrower relationship.
- Whilst standard LMA recommended forms do not restrict common synthetic risk transfer structures where ownership of the loan is not transferred or assigned, bespoke transfer and confidentiality restrictions negotiated deal-by-deal are increasingly creating uncertainty, operational friction and additional cost for all parties to transactions.
- Early discussion and targeted drafting, such as that provided in LMA guidance, can give borrowers appropriate protections, while preserving lenders' need to manage and distribute risk efficiently, supporting continued lending and greater loan market liquidity.

Introduction

Credit risk transfer products (CRT) are an established and necessary part of bank portfolio management. By transferring some or all of the economic credit risk associated with loans to third-party protection providers, lenders can manage concentration risk, diversify exposures and, where the applicable regulatory conditions are met, obtain capital relief. This can support additional lending capacity and wider liquidity in the loan markets, while allowing the originating lender to remain lender of record and preserve its relationship with the borrower/sponsor.

Significant risk transfers (SRT) and credit risk insurance (CRI) are two of the most popular types of CRT used in the EMEA loan markets. Although their structures differ, each involves a synthetic transfer of credit risk rather than an immediate sale of the underlying loan. They can therefore be distinguished from all types of "true" loan sale, whether that be achieved via legal transfer or a funded sub-participation arrangement.



In order to enter into a CRT in respect of an individual loan or loan portfolio, lenders should ensure that there are no contractual restrictions contained in the underlying loan agreement(s). Such restrictions can take many forms, but usually relate to fetters on transferability or ability to disclose information. Whilst LMA recommended form loan documentation does not restrict a lender from entering into or complying with a CRT transaction where there is no transfer or assignment of ownership of the underlying loan, negotiated facility agreements increasingly extend transfer or confidentiality restrictions beyond the LMA position. Furthermore, broad or ambiguous provisions may inadvertently capture SRT or CRI transactions, creating uncertainty, delay and lengthy case-by-case legal analysis for all parties involved.

Why credit risk transfer products matter to the EMEA loan markets

Banks use CRT to manage credit exposures and capital costs. Their importance has also increased as regulatory and supervisory developments have required lenders to manage balance-sheet capacity efficiently. A lender may use CRT to reduce exposure to a particular borrower, sector, geography or client group. If the transaction satisfies relevant regulatory requirements, it may also support regulatory capital relief.

The benefits, however, extend far beyond the originating lender. Capital released or capacity created through effective risk management may be redeployed, including into additional lending. Borrowers may benefit from greater competition and choice, while the lender can often remain the contractual lender throughout the life of the loan. From the investor perspective, credit protection providers, including insurers, pension funds, multilateral development banks, asset managers and specialist credit funds, gain exposure to loan-market risk and return without necessarily acquiring or administering the underlying assets.

Well-designed CRT connects bank origination with a broader pool of risk-bearing capital

Two common structures



Significant risk transfer

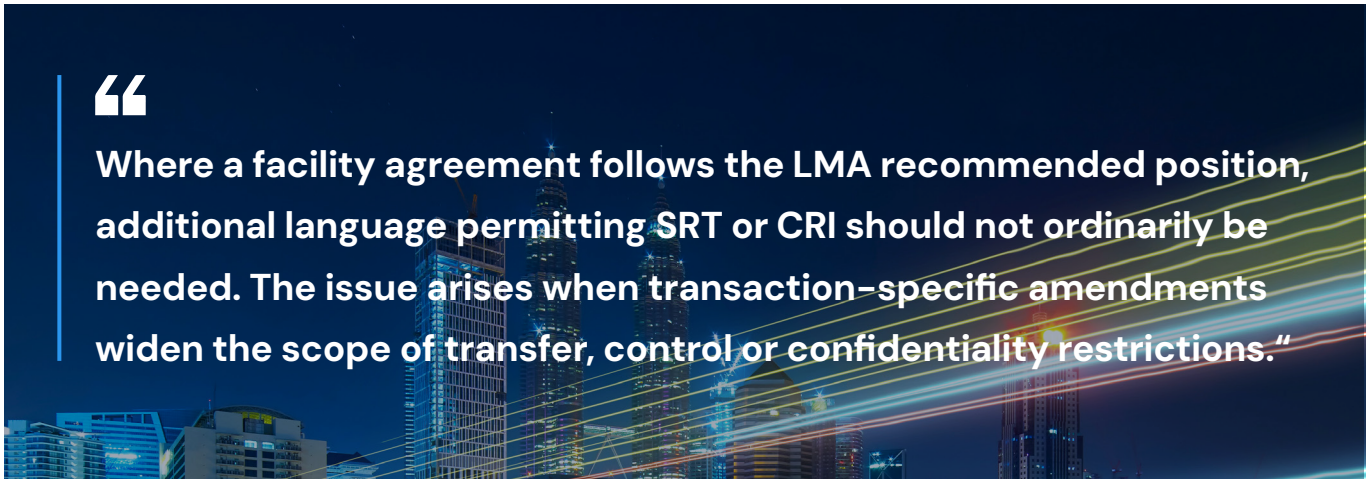
SRT transactions typically transfer a portion of the credit risk in a portfolio of loans from a lender to one or more protection providers. The transfer is synthetic: the lender retains ownership of the loans, while the protection provider assumes agreed economic exposure under a contract or related series of contracts. SRT structures are generally tranched and may be funded or unfunded. They can be documented bilaterally, through a credit default swap or financial guarantee, or through notes issued by the lender or a special purpose vehicle.

SRT counterparties generally do not receive contractual rights to direct how the lender exercises voting or similar rights under the underlying loan documents. Information may be disclosed for due diligence and reporting but portfolios may be presented on a blind (i.e. without borrower identities) or a disclosed basis.



Credit risk insurance

CRI protects a lender against loss arising from a borrower's failure to pay principal and, where covered, interest under one or more insured loans. The lender pays a premium and remains owner of the loan. CRI differs from SRT in two important respects. First, the insurer may have consultation or consent rights in relation to specified lender decisions. Secondly, after paying a claim, the insurer may have subrogation rights or a contractual right to require transfer of the insured participation. That said, whilst CRI may involve customary consultation or consent rights, particularly for material changes to the economics of an insured loan, it is worth noting that the motivations of the insurer are likely to align with the borrower in the majority of cases (see *Understanding borrower motivations*, below).



CRT eligibility: the documentary starting point

Under LMA recommended form investment-grade and leveraged facility agreements, lender transfer provisions regulate transfers and assignments of ownership. They do not purport to prohibit other transactions that leave the lender of record unchanged. As a result, standard LMA drafting does not restrict common SRT and CRI structures.

The LMA confidentiality framework also contemplates disclosure to a person with whom a lender enters into, or may enter into, a transaction under which payments are made by reference to finance documents or obligors. Subject to the prescribed confidentiality protections, this category will typically include a CRT counterparty and, where relevant, investors financing an SRT transaction.

As a result, where a facility agreement follows the LMA recommended position, additional language permitting SRT or CRI should not ordinarily be needed. The issue arises when transaction-specific amendments widen the scope of transfer, control or confidentiality restrictions. Most importantly, this is not always done in a clear, targeted or even intentional way, increasing potential for uncertainty and lengthy legal analysis for all parties to the transaction.

Where negotiated restrictions create friction

In some EMEA loan transactions, borrowers seek to extend transfer restrictions to sub-participations, sub-contracts or arrangements having substantially the same economic effect. Other provisions focus on whether a transaction could confer consultation, consent or other influence over the lender’s exercise of rights. Depending on the drafting, these restrictions may capture SRT or CRI even though the lender remains lender of record and the protection provider has no direct rights under the facility agreement.

Requirements can range from borrower consent to prior notification. The consequences of non-compliance may be material, including restrictions on voting, defaulting-lender treatment or loss of reimbursement and indemnity rights.

From an operational perspective consequences include:

- Pre-trade diligence becomes slower because bespoke clauses must be identified and interpreted loan by loan.
- Portfolio transactions may be difficult to execute where advance notice or transaction-level information must be provided across multiple obligors at the same time.
- Operations teams may need manual tracking throughout settlement, post-closing administration and ongoing compliance.
- Uncertainty can reduce the attractiveness of a loan for risk distribution, syndication or secondary market activity.

The outcome of agreeing to such clauses at the point of loan origination also has a direct impact on loan market liquidity as restricting the ability of a bank to distribute credit risk ultimately stymies its capacity to lend more.



Understanding borrower motivations

Understanding borrowers’ motivations is essential to addressing these restrictions during the negotiation process since explaining why neither SRT nor CRI need give rise to borrower concerns can help facilitate a more constructive discussion and ensure that drafting is targeted and clear.

Borrowers commonly raise concerns in three key areas: third-party influence over lender decision-making, the protection of confidential information and the preservation of the borrower–lender relationship.

Influence and voting

In an SRT transaction, the protection provider will usually have no contractual right to direct the lender’s exercise of rights under the loan agreement. The lender remains exposed to part of the underlying risk. CRI may involve customary consultation or consent rights, particularly for material changes to the economics of an insured loan, but the insurer’s incentives will commonly favour a sustainable outcome rather than conduct that unnecessarily increases the amount of a claim.

Confidentiality

SRT involves pools of loans and may not disclose individual borrower identities. Investors are generally sophisticated institutions and are commonly subject to contractual confidentiality restrictions. CRI necessarily requires underwriting information and ongoing disclosure of matters relevant to a potential claim. Insurers, and any reinsurers receiving information, are also subject to confidentiality frameworks and regulatory or prudential obligations.

Continuity of relationship

SRT does not generally transfer ownership of the loan, so the lender-borrower relationship continues. Under CRI, subrogation or transfer rights usually become relevant only after an insured payment default and payment of a claim. At that point, the facility agreement may already permit transfers more freely because an event of default is continuing.

The importance of a proportionate approach

The relevant question is whether the drafting addresses a concrete borrower concern. Restrictions should distinguish synthetic risk transfer from a sale of the loan, and customary protections from rights that give a third-party direct control or enforcement rights.

Potential drafting solutions

Where loan documentation contains restrictions that could potentially affect the entry into CRT transactions, the LMA has this month published a detailed guidance note which presents two alternative drafting approaches to address restrictions in loan documentation that could limit lenders' ability to enter into CRT transactions.

The objective of the drafting is not to remove legitimate borrower protections. It is designed to ensure that documentary restrictions are appropriate and facilitate the legitimate use of SRT and CRI, rather than be drafted so widely that day-to-day portfolio management becomes difficult or impossible.

Option 1: an override clause

A standalone clause can provide that nothing in the facility agreement restricts a lender from entering into a defined "Permitted Credit Protection Transaction". The permission can also address disclosure to approved counterparties, investors and relevant advisers, subject to agreed confidentiality conditions. This approach is particularly useful where negotiated restrictions are complex or appear in several parts of the agreement.

Option 2: a targeted carve-out

Alternatively, parties can amend the "Pre-Approved New Lender List" concept, or the relevant transaction-specific equivalent, so that approved insurers and SRT counterparties fall within a pre-agreed category. This creates a carve-out from broader transfer and confidentiality restrictions and may suit transactions where the parties favour a defined class of acceptable protection providers.

Common safeguards

Under either approach, the permission can be limited to transactions meeting specified conditions. These include:

- The transaction is SRT or CRI, rather than an unrestricted category of credit derivative or risk transfer.
- The protection provider meets agreed eligibility criteria, such as an appropriately authorised insurer or a defined institutional SRT counterparty.
- The lender remains lender of record and the transaction does not itself transfer or assign ownership of the loan.
- The protection provider receives no direct enforcement or step-in rights, other than agreed CRI subrogation or post-claim transfer rights.
- SRT counterparties receive no control rights; CRI consultation or consent rights are limited to customary provisions.
- Disclosure remains subject to the agreed confidentiality framework.

A better transaction process

The drafting solution is only part of the answer. The need for CRT by lenders should be considered early, when the parties agree the underlying commercial terms and instruct counsel. This allows the borrower and lenders to discuss any concerns and instruct counsel accordingly, long before the transaction is finalised.

Identify

Identify whether proposed transfer or confidentiality amendments could capture synthetic CRT.

Test

Test the clause against the real features of SRT and CRI, including ownership, control, disclosure and post-claim rights.

Document

Document a clear permission, carve-out or agreed counterparty category, with safeguards stated expressly.

Conclusion

SRT and CRI are vital and necessary portfolio management tools in the EMEA loan markets. They can support prudent risk management, more efficient use of capital and the continued availability of credit, while allowing lenders to preserve their borrower relationships. The standard LMA documentary position facilitates these transactions. Problems arise where bespoke restrictions are broader than necessary, insufficiently clear or scattered across different parts of the loan agreement because they create blockers that impact important risk distribution tools used by banks to manage their balance sheet and facilitate lending.

A more effective approach is to focus on the substance of the proposed transaction: whether ownership changes, whether a third party can control lender decisions, what information is disclosed and what protections apply. Early engagement and targeted drafting can protect legitimate borrower interests without creating avoidable barriers to ordinary risk management and loan-market liquidity.

About this paper

This Insights paper is a concise market-facing overview derived from the LMA's draft guidance on credit risk transfer transactions in the EMEA loan markets. It is not legal, regulatory or accounting advice. Transaction parties should consider the terms of the relevant facility agreement and obtain advice on their specific circumstances.

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Authors



Amelia Slocombe

Managing Director – LMA

amelia.slocombe@lma.eu.com



Faizal Khan

Partner – Clifford Chance

faizal.khan@cliffordchance.com

To learn more about the LMA's work to support efficiency, liquidity and transparency in the EMEA loan markets, please visit the **LMA's website:** www.lma.eu.com