Navigating Change
LMA 10th Syndicated Loans Conference
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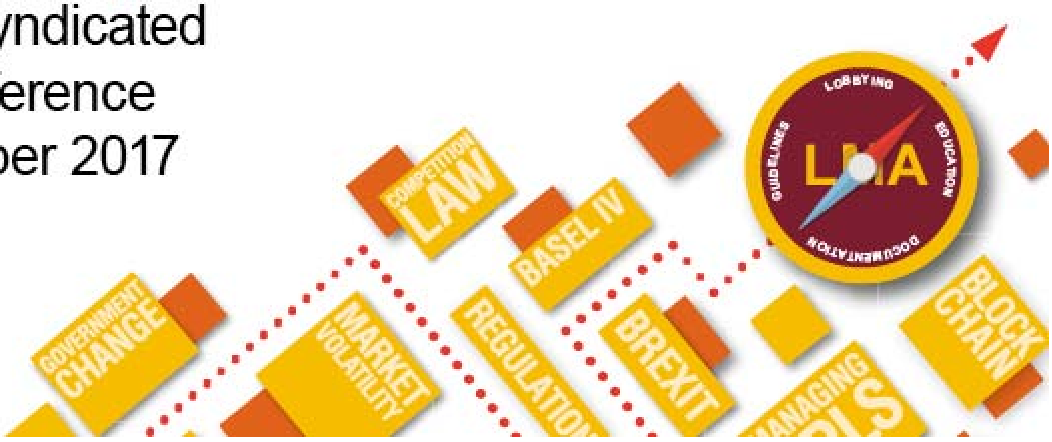

REGULATORY PANEL: REVIEW OF CURRENT POSITION – 'HEADWINDS AND HIGH SEAS'

This panel provided an insight on into key regulatory issues impacting the syndicated loan market, namely: Brexit negotiations; the European Central Bank's guidance on leveraged transactions; competition in the syndicated loan market; and the FCA's speech on the potential discontinuance of LIBOR as a benchmark.

The panel was chaired by **Nicholas Voisey**, Managing Director at the LMA. He was joined by **Mark Campbell**, Partner at Clifford Chance; **Edward Chan**, Partner at Linklaters; **Christopher Kandel**, Partner at Latham & Watkins; **Greg Olsen**, Partner at Clifford Chance; and **Phillip Souta**, Partner at Clifford Chance.

BREXIT

The main focus of the UK and EU in relation to Brexit has been the negotiation of a withdrawal agreement and any transitional arrangements. These negotiations have been separated into two phases, with Phase I dealing with the rights of citizens, financial settlements and Northern Ireland, and Phase II dealing with transitional issues. In this respect, the market would need to see some progression from Phase I to Phase II by January 2018, with a draft withdrawal agreement finalised by October 2018. This timescale takes into account the six month ratification period required in order for a withdrawal agreement to be in place by 29 March 2019. However, transitional arrangements could not be considered until Phase II of the negotiations, which cannot commence until a mandate has been granted to Michel Barnier from the European Council. Given that the timetable has already been eroded by the UK general election, and a further five weeks may be needed to approve the Phase II mandate, there is a significant risk that the UK and EU may run out of time to agree a withdrawal agreement. The likely outcome is that a withdrawal agreement is agreed by 29 March 2019, with some heads of terms agreed upon and provisions made for transitional arrangements to be put in place. During the transitional period, both parties can seek to negotiate a free trade agreement.

One of the main issues in relation to Brexit and financial services is the loss of passporting rights. Financial institutions rely on the EU credit institution passporting regime to enable them to provide financial services across the EU. However, once Brexit has been fully completed, this passport will no longer be available to credit institutions in EU27 countries which operate in the UK, or to UK-based credit institutions operating in the EU. Instead, market participants will be required to obtain a local licence. Market participants will need to arrange their businesses to account for the loss of passporting, absent any transitional arrangements.

There has been concern in the market as to whether English law will continue to be used in loan documentation following Brexit. However, the English Courts are highly regarded and commercial in their approach, and English law provides certainty in the form of predictable, commercial results for parties. The Courts also have a strong history of not interfering with the contractual intentions of the parties when negotiating agreements. In this respect, English law and English Courts will remain relevant for international commercial transactions.

COMPETITION

In the years following the financial crisis, the syndicated loan market has been increasingly scrutinised by competition authorities. Earlier this year, the UK's Financial Conduct Authority (FCA) issued several notice letters to banks in the industry. The European Commission also recently announced that it would be undertaking a review of the syndicated loan market. In explaining the rationale behind the study, the Commission commented that syndicated lending is characterised by close cooperation, with negotiations not taking place on a transparent trading platform; which the Commission considers makes the market vulnerable to anti-competitive conduct. This view is considered to be somewhat controversial within the market, given borrower-friendly conditions in the market and the competitive landscape. When surveyed, 91% of delegates described the market as being competitive.

The Commission is currently in the process of selecting a third party to conduct the market study, which is envisaged to take the form of a detailed review across six jurisdictions: UK, Germany, France, Netherlands, Poland and Spain. Details of the party appointed will be announced towards the end of Q3 2017. Following this, there will be a nine month process in which the party appointed will conduct a desktop review, then a pilot, followed by the full study. This will involve contacting market participants through written requests for information and telephone interviews. The final report is likely to be published by the end of Q3 2018, with a consideration of two key areas. The first of these involves an assessment of the market, with a focus on market structures and three main areas of lending: project finance, leveraged buyouts and infrastructure projects. This will also take into account regulatory effects on the market. The second area will focus on the relevant factors and considerations in terms of competitive interaction within the market, covering general competitive dynamics (including loan origination), formation and operation of syndicates, restructuring and refinancing, ancillary arrangements and future developments.

There are a number of potential outcomes to the study which lenders should be aware of, including the scope for a broader sector enquiry, legislative proposals to remedy any systemic issues and potential enforcement action. Competition issues should be considered in the context of origination, syndication and secondary trading. In the case of origination, market participants should be aware of information exchange in respect of general and specific market soundings and exchanges between lenders, either when considering participations or when electing to be an arranger. Parties should also consider the relevance of existing client relationships, intermediaries, the possibility of tying and cross-selling. Syndication issues may arise in relation to operational market flex and where there is potential for additional competition in finalising the syndicate. In relation to the secondary market, parties should be aware of issues around information exchange. It is recommended that lenders implement safeguards to prevent anti-competitive behaviour; this could take the form of increasing borrower involvement and keeping contemporaneous file notes.

ECB GUIDANCE ON LEVERAGED TRANSACTIONS

In May 2017, the European Central Bank (ECB) issued guidance on leveraged transactions. The guidance, which takes effect from November 2017, requires banks to implement a comprehensive and worldwide management information system, both for monitoring and granting approvals for leveraged finance transactions. The guidance considers a transaction to be leveraged where the ratio of total debt to EBITDA exceeds 4x or where the borrower is owned by a financial sponsor. Transactions where leverage exceeds 6x are not prohibited by guidance, but should remain exceptional. In addition, all leveraged transactions should indicate an ability to repay either all of the senior debt within 5-7 years, or 50% of total debt in the same period. The guidance initially excluded adjustments to EBITDA, but these are now been permitted provided they can be justified. PIK debt and subordinated shareholder loans continue to be regarded as debt under the guidelines, but this is contentious.

There are a number of distinctions between the ECB guidance and similar guidelines in the US. One significant difference relates to coverage; the US guidelines applied to 70% of the market upon implementation. This resulted in an immediate effect on reducing leverage, and meant that banks lost market share in the US to those lenders not subject to the regulations, or to funds which almost never fall within the scope of the US guidelines. The ECB guidance is also stricter in its definition of leveraged transactions, with the US guidelines instead providing a non-prescriptive list of factors which may indicate that a transaction is leveraged. However, the ECB have accommodated for this distinction by providing a number of exceptions, to include real estate and project finance. Finally, the ECB guidance requires independent vetting within the bank of two factors: pricing and enterprise value of the borrower.

Market participants should be aware that, while onerous, the guidance is non-binding and there is not, therefore, a risk of loan agreements becoming unenforceable or illegal. However, facilitating transparency in the market has been a core aim of the ECB in producing the guidance and this should be taken into account by lenders. In particular, the guidance focuses on processes, such as defining, measuring and monitoring the leveraged lending activities of a bank.

LIBOR

Andrew Bailey, Chief Executive Officer of the FCA, recently delivered a speech on the future of LIBOR. Since the financial crisis, the level of bank funding through short term borrowing has been too low, such that LIBOR has, to some extent, been determined by reference to expert judgment by the LIBOR panel banks rather than on the basis of transactional data. Regulators have criticised this approach, as a transaction-based methodology is more effective in minimising the risk of rates being manipulated. The FCA therefore announced that, whilst the market is free to continue using LIBOR post-2021, institutions should not rely on LIBOR being available after that time. After 2021, the FCA will not compel LIBOR panel banks to submit quotes. The FCA stated that the onus is on market participants to develop alternative benchmarks and to ensure that contracts entered into now have sufficiently robust fallbacks to facilitate a smooth transition to any new alternative benchmark.

Regulators have been looking at alternative risk-free rates, based on transactional data, which can be used in the derivatives market, for each of the currencies for which LIBOR is quoted. Each of these rates is a historical overnight rate, unlike LIBOR which is a forward looking term rate. LIBOR has been considered as useful for loans because it is seen as a proxy for a lender's cost of funds (albeit increasingly less so given the more burdensome regulatory and operational costs of lending) and lenders can therefore calculate a suitable return by taking LIBOR and adding an appropriate margin. In contrast, a risk-free rate is only intended to express the market view on interest rates, and a transition for loans to such a rate will therefore be difficult unless some way can be found of taking into account the difference between the rate itself and the cost to the lender of funding the loan. This could be achievable through increased margins or through a credit spread which represents the difference. The core challenge for the loan market is to find alternatives to LIBOR which are forward looking, provides for term funding and which do not give rise to basis risk.

In terms of documentation, there are some protections within the LMA's suite of documentation. Whilst there is no specific wording in the documents which provides for a transition to whichever rate replaces LIBOR, there are a number of fallbacks. These include a fallback to a reference bank rate or a lender's cost of funds; optional language allowing for the selection of a different screen rate with the approval of the borrower and the majority lenders; and provisions for "such other page or service displaying the relevant rate as the agent may specify". However, none of these protections fully cover the introduction of a new rate, wording for which can only be included once an alternative rate has been identified; the LMA will therefore continue to assess the situation as more information comes to light. When surveyed, 66% of delegates believed LIBOR would no longer be used as a benchmark in 2022.