LMA & LSTA Conference Summary (7 March 2018)

On 7 March 2018, the LMA and LSTA held their joint annual conference at the offices of Allen & Overy in London. Over 400 industry professionals were joined by 30 senior market experts who delivered sessions covering the current economic and geopolitical outlook of the global loan market, a comparison between US and European loan market trends and deal terms, an overview of the current role of blockchain and crytocurrencies, and an update on Brexit and LIBOR.

Session 1: Global Economic Outlook

The outlook for the world economy is largely positive with expectations high across the board and 2018 predicted to be the best year for global growth since the financial crisis. Global growth is predicted to hit around 4%, EU growth to hit 2% and the UK to hit 1.3%, underperforming in relation to its neighbours. In contrast with this optimistic sentiment, there are several factors which may impact GDP growth. These include increasing protectionism and loosening of fiscal policy from the US; authoritarian drift in jurisdictions such as Hungary and Poland; growing uncertainty over central banks' monetary policy; and heightened geopolitical tensions in the Middle East and Asian Peninsula.

In Asia, strong growth has resulted in increased consumer spending power, the same can be seen for Middle Eastern jurisdictions not directly involved in conflict. A rise in the prices for oil and other key commodities has provided a much needed stimulus for the OPEC nations and emerging economies. Brazil is expected to push forward out of recession with growth predictions of around 4%.

The US Fed has stopped re-investing its bond yields into corporate bonds, and has begun loosening its fiscal policy despite warnings that it may be at the top of the economic cycle. This poses a risk to the level US national debt, as well as posing further risks to US trading partners. The rest of the world is waiting to see the effects of this experimental approach. Inflation, liquidity and market volatility have remained at manageable levels, but this may change as central bank interest rate rises are anticipated in both the Europe and the US over the course of 2018.

Key threats to global growth include growing US protectionism, which has prompted a response in Europe and China, and increasing uncertainty over the monetary and geopolitical policy trends of major economies. However, global growth has been deep and consistent, assisted by technological advances and increasing business and consumer confidence. Some economists have predicted a slowdown may be on its way as early as 2019, but, despite these predictions, the overall trend suggests that 2018 will be a strong year for global growth.

Session 2: UK and US Loan Markets: Trends and Deal Terms

A look back at 2016 showed that despite Brexit and the US election, the European and US loan markets returned 6% and 10.2% respectively in 2016. It saw the European institutional investor base reach 70%, a record high, and more than 50% of European deals being cov-lite, evidencing Europe's shift to a high yield bond-style covenant packages. 2016 saw both markets dominated by refinancing activity, yet there was still a divergence on the use of flex rights.

2017 saw a record level of leveraged lending across the two markets, with the US totalling $646 billion and Europe totalling $136 billion. Record highs in global supply and demand levels were also reached in 2017 and global secondary markets were trading at close to post-recession highs. The two markets saw an increase in the trading of "technicals" and high levels of CLO issuance, despite the risk retention regulation impacting the US market.

The ambitious new US Tax Act means that for US institutions it will no longer be advantageous to be a non-US Parented Company. Due to the 30% cap on interest deducibility, issuers may want to move debt outside of the US. Issuers must also be aware that credit agreement drafting will be impacted and that baskets will need close attention to how they are structured.

European deal terms have become even more aggressive due to surpus demand. An example is the adoption of borrower friendly terms such as builder baskets, grower baskets and EBITDA addbacks. Despite increased flexibility for the borrower, lenders are seeing a push for more flexible deal terms in grower components, size of baskets and Most Favoured Nation (MFN) sunset provisions. For example, 35% of deals in 2017 had a MFN sunset period of only 6 months. 2017 saw the rise of incremental debt capacity in Europe. Incremental debt provisions, most frequently found in the large cap space, are having increasing prevalence in the middle market. In the US market, differing to the European market, flex terms includes pricing and the market has seen pricing flex impact OID, interest rates and upfront fees. The European market saw an increase of 10% between the second half of 2016 and the first half of 2017 in the percentage of loans using portability debt provisions. This provision is allowing sponsors to avoid triggering change of control provisions when selling equity in the borrower.

Session 3: Direct Lending in the US and Europe

The lending market has traditionally been dominated by banks; however, over the last two decades direct lenders have secured a foothold in the market. Direct lending players include credit funds, alternative asset managers, business development companies, finance companies and debt-fund affiliates of private equity funds. Most direct lending occurs in the middle-market due to constraints on ticket size, but this suits direct lenders as they are predominantly focused on debt-yield as opposed to secondary market trading; this means that they are unfazed by the illiquidity of middle-market credits.

The competitive advantages of direct lenders over traditional banks include not being subject to the same regulatory requirements (US Leveraged Lending Guidelines or ECB Guidelines), allowing them to take on more highly leveraged deals and complex funding structures; the ability to provide greater pricing certainty to borrowers by bypassing syndication; the ability to provide a consistent lender-borrower relationship; and the ability to execute transactions within a shorter timeframe. In addition, direct lender deal terms are usually more lender-friendly than those seen in syndicated deals, which creates a niche market for sponsors who wish to balance less favourable documentation terms and pricing with the need to build certainty into complex funding structures.

Banks still retain their advantage in relation to the provision of ancillary facilities and the ability to offer lower pricing (due to their syndication and underwriting capabilities), but the trend indicates a move toward an increasing direct lender presence in the market. For comparison, the US bank loan market is somewhere in the realm of $2 trillion and the US direct lending market sits at around $400 billion, so there is certainly ample room for direct lenders to increase their market share. There is, however, a growing symbiosis between traditional banks and direct lenders, allowing borrowers to benefit from high availability of funds and competitive pricing.

Amongst all of this, a silver lining for US banks is that the Leveraged Lending Guidelines are to be revisited. This may result in a relaxation of banking rules to allow increased bank presence in the middle-market.

Session 4: Brexit: A practical Dialogue

This year's Brexit panel focused on the anticipated timelines, the worst case scenario of a "hard" Brexit, and issues directly affecting the financial services markets. In terms of timelines the key topics are: the Withdrawal Agreement; the future agreement between the UK and EU; agreements between the UK and Third Countries; and the process of resetting UK and EU legislation. The central issue is timing; with the indicative deadline for the conclusion of substantive talks being October 2018, negotiators must balance this pressure with the need to reach an agreement that reflects the needs of both sides.

In a worst case scenario, where no agreement is reached, the EU treaties will cease to apply to the UK from 30 March 2019. For financial services, this would mean a loss of all passporting rights between institutions operating between UK and EU (as well as UK and EEA) offices, and the applicability of requirements under the 'third country' regime. It is worth noting that of the top 40 EU banks, which are involved in over 90% of syndicated loan deals, only 6 have teams which reside entirely in EU-27 jurisdictions. This could have far reaching effects as institutions would be prohibited from performing any critical functions within the UK.

In terms of specific considerations for financial services, if regulatory divergence occurs it may be difficult for institutions to justify maintaining a large UK presence. Additionally, it is worth considering the technical work that institutions will need to undertake to retrain staff and alter IT systems to deal with the changes that may arise. Lastly, firms will need to consider the steps needed to ensure contractual continuity after Brexit. This may come with a significant cost, and could include a need to amend contracts to account for changes in KYC and tax requirements. It is recommended that all credit institutions have plans in place to deal with these issues should the UK find itself in a worst case scenario after Brexit.

Session 5: Trade, Trust and Trump: Thoughts on Geopolitical Risk in Developed and Emerging Economies

Following the unanticipated political events of the previous year, there was a greater understanding of the disruptive power of political risk in 2017. Election norms are no longer taken for granted, with economic and political thinkers alike seeking answers to what is driving the current geopolitical climate. The most imminent risk to the global economy at present is the trade war that President Trump has laid bait for through his action against trade agreements and plans to dial up import tariffs. The outcome of this could be a retaliation from the rest of the world. The USA is not the only country to impose new, aggressive trade tariffs - India has raised tariffs to 30% for agricultural products. There is brewing political potency around tariffs, fuelled by mixed global views towards protectionism. Greater scrutiny of external investment has been driven up by post 9/11 national security suspicions and increasing threat from cyber security. The ascent of protectionism is linked also to broader political dynamics, such as the rise of populism and an erosion of public trust observed in many nations facing widening domestic inequality.

A split is forming in the EU between those countries accepting popularism and those rejecting the movement. Cleavages are being formed where parts of society are feeling alienated and "left behind". Recent research showed that 47% of Europeans born after 1980 felt they have not benefitted from democracy. Nevertheless, we have seen grassroots political activism change leadership at the top, for example in 2017, three GE leaders had to step down after allegations of corruption.

With the increasing weaponisation of capital, trade and investment, comes the return of Great Power Politics. One example of this involves China reprimanding Australian airline Qantas for putting Tibet and Taiwan in an online drop down menu, prompting the Chinese ministry of foreign affairs to make a statement calling for companies to "respect China’s sovereignty and territorial integrity". There is mounting geopolitical risk with nations going head-to-head in competition on trade and security, leading to question: how far will this rivalry go?

Session 6: Blockchain and Cryptocurrencies

The simple definition for Blockchain is a transaction processed "via consensus by multiple counterparties". This block of transactions are tied together mathematically to create a "tamper-evident" chain of transactions. Pre-financial crisis data complexity was ever increasing, with traditional data structures acquiring data and then enhancing it to make it fit for purpose. Blockchain on the other hand runs on a different business logic, which runs all processes on the same strip of code. A simplification process will be needed for blockchain to work and much of the infrastructure required for full utilisation does not yet exist. However, players in the blockchain field are speculating that this process will be enhanced unilaterally over time.

Cryptocurrencies were born out of a lack of trust for the establishment. They require no central issuer, but have no currency guarantee. The algorithmically based cryptocurrency is based on a struggle between what people feel "value" is and what regulators state "value" is. A cryptocurrency bases values on the transfer of ownership, this transaction is propagated and validated by a network of nodes after a cryptocurrency wallet signs the transaction using a private key. This transaction will now be included in the next block to be "mined" on the blockchain. Confirmation of this transfer of value, or transaction, will appear in a new block. There are many cryptocurrencies currently being traded, amongst them are Bitcoin, Ethereum, Zcash, Dash and Ripple. A cryptocurrency can "fork", reflecting a change to blockchain protocol. A "hard fork" can occur for any reason, including to innovate the cryptocurrency to provide different types of value that can be utilised within different areas. For example Bitcoin's hard fork into Bitcoin Cash and Bitcoin Gold. But how do you regulate a virtual pocket like a cryptowallet? Cryptowallets put financial responsibility into the hands of currency owner. This is where banks will remain prevalent, as individuals prefer to transfer the responsibility of their day-to-day finances to their bank. To prepare for this future, banks and regulators will have to consider the role of the agent, behavioral change, cryptocurrency regulation, trust and technology barriers.

Session 7: Developments in Benchmark Replacement/LIBOR

The process of global interest rate benchmark reform (and eventually replacement) essentially began in 2014 following the Financial Stability Board's Report on Reforming Major Interest Rate Benchmarks. This work was put into focus by the July 2017 speech by Andrew Bailey, Chief Executive of the UK Financial Conduct Authority, which called for a transition away from LIBOR given questions over its long-term sustainability. Various national working groups have been formed to identify and, as required, reform alternatives to LIBOR in the five currencies for which it is currently quoted. Until recently, the working groups focused largely on the derivatives market due to its relative size in comparison to cash markets. Recent work has been focused on facilitating a broad-based transition away from LIBOR to alternative reference rates for cash products.

National working groups have identified near 'risk-free rates' (RFRs) for each of the LIBOR currencies and these should work well for much of the derivatives market. However, for the cash markets (such as the syndicated loan market) these rates present several problems. A key issue for loans is that RFRs are overnight rates and are not forward looking. The lack of a term-rate structure means that the RFRs do not reflect credit risk and the term liquidity premium for longer dated funds. Work is being undertaken to see whether an IOSCO compliant forward looking rate can be created using data from RFRs.

In relation to the facilitation of a transition away from LIBOR, the LMA and LSTA have been working with other trade associations to ensure that the approach taken in the financial markets to the transition are convergent. Reference rate fallback language is being considered, but a lack of consistency between financial products could cause issues. The market needs to agree on an approach that deals with the issues faced by all relevant stakeholders, as well as agreeing on how to deal with any shifts in pricing or value caused by the difference in benchmark rates.

An important issue is that there are differences between the selected RFRs. For example, SOFR (the US RFR) is secured against US Treasury funds whilst SONIA (the sterling RFR) is unsecured. There will also be differences in terms of publication timings and this may well cause currency specific operational and documentation issues. The LMA, LSTA and other trade associations are working together to reduce these potential problems and to create market-led solutions in conjunction with the national working groups. Market participants should already have begun the process of reviewing existing documentation, and should be looking to incorporate sufficient flexibility into new credit agreements to allow for future amendment, as well as getting involved national working group discussions.

Session 8: Spotlight on Regulatory Developments

When looking back at the financial crisis, it's magnitude and huge impact on the global economy came as a shock to many in the private and public sector. Before it hit, there was however a sense that something was off, as financial products which made no logical sense were entering the market, such as CLOs within CLOs. From the perspective of the Single Resolution Board (SRB) in Brussels, the first action was to deal the high risk banks. The liquidity problem that this crisis brought was huge, with many cross-border banks, which were systemic in various jurisdictions, having grown too fast for their own good. The root of the crisis was the mispricing of risk. The crisis outlined a need for risk retention to be addressed by regulators, supervisors and the market. There needed to be a change in the internal culture and behaviour of the banks.

Looking forward, attention to the pricing of risk must stay in the forefront of internal culture for the private sector and supervisory focus for the public sector. For the SRB, this means dealing with issues in the 17 Euro nations and following the banking resolution introduced by the ECB. Provisions to ensure that all banks are "resolvable" are being put in place, for example making certain there is sufficient bail-in capital from the relevant shareholders. When banks are close to or experiencing a crisis, the SRB will step-in to action the appropriate measures. Momentum in the market for deregulation is still far off. The European economy is still healing from the financial crisis and there are still many banks struggling with NPLs.

Session 9: Competition Enforcement

Whilst commentators are not entirely clear as to what the Financial Conduct Authority's (FCA) new competition powers will mean for the market in terms of their approach to supervision and enforcement, toward the the end of 2017, the FCA issued a Statement of Objections against four UK asset managers for the alleged sharing of information relating to pricing of shares. A decision on this case will be made before the end of 2018, and will give an indication as to the expected approach of the FCA to such scenarios in future.

One key theme which can be drawn from the FCA's investigations is their focus on the exchange of information between parties. The FCA understands that in certain financial markets, especially in the syndicated loans market, competitors will need to be in contact with one another – and that the reasons behind these are legitimate and pro-competitive. But the FCA are looking to prevent illegitimate conversions, such as that which led to it issuing a Statement of Objections in 2017.

As regards the FCA's new concurrent powers, it is expected that its approach to competition issues will evolve significantly moving forward. The FCA now has concurrent powers under the Competition Act and Financial Services and Markets Act (FSMA), which provides it with the ability to look closer at firms' activities than any other financial services regulator in the world. Whilst there is overlap between the two sets of powers, firms are concerned about whether the prescribed leniency for whistleblowers under the Competition Act and the benefits of self-reporting under Principle 11 will be negated through the application of the more stringent rules under FSMA.

Alongside these developments, the European Commission is currently conducting an in-depth study into syndicated lending activities in six EU Member States: Germany, France, the Netherlands, Poland, Spain and the UK. The EU Commission believes that the opacity of the syndicated lending market, coupled with recent enforcement action in Spain against several banks, suggests that anti-competitive behaviour could take place. The key risks arising out of this study are that: (i) actual competition issues could be uncovered, leading to formal investigation; (ii) institutions may discover, after conducting self-audits, that competition issues exist which must be brought forward to the regulator; and (iii) third parties performing ancillary functions may be involved in anti-competitive behaviour. The materialisation of any of these concerns would likely lead to further investigation and possible enforcement action.

In terms of compliance recommendations for syndicated lending, the panel stressed that the threshold in relation to anti-competitive "information exchange" is rather low. It is recommended that competitors avoid any potentially sensitive conversation where possible, and to keep records of any communications between themselves. On top of this, it is recommended that institutions maintain their originations and syndications teams as separate and distinct entities, and provide training to staff in high-risk functions. Lastly, it is always a sensible idea to provide the borrower with prior disclosure as to the required interactions between competitors and to seek their consent to these interactions for the duration of the syndication process.

The LMA would like to give special thanks to the speakers who devoted their time to this year's LMA & LSTA Conference.