LMA & LSTA Conference Summary (6 March 2019)

On 6 March 2019, the LMA and LSTA held their joint annual conference at the offices of Allen & Overy in London. Over 300 industry professionals were joined by 28 senior market experts who delivered sessions covering the current economic and geopolitical outlook for the loan market, a comparison between trends in the US and European loan markets, insight from direct lenders as well as the issues of Brexit, green lending, quantum computing, LIBOR, sanctions and competition enforcement.

Session 1: Global Economic Outlook – What's Ahead

The global economy is expected to grow at a slower, but still respectable, rate this year. Whilst 2017 / 2018 proved to be the best years for growth since the financial crisis, the IMF had predicted a slowdown this year. The expected GDP growth in developed economies was reduced from 2.3% in 2018 to 2% in 2019, and a similar trend is expected to follow in respect of emerging economies, with 4.6% GDP growth in 2018 and an expected growth of 4.5% in 2019. This is due to several key factors, including increased protectionism. Central banks around the world have cautioned against future interest rate hikes given the risks of recession in 2020.

Fed funds rates in the US had increased materially, however the Fed has now signalled that rates may stay on hold through 2019. Following the election of Donald Trump into office, protectionism has been on the rise, to the clear detriment of the global economy. For example, the imposition of steel tariffs by the US triggered equivalent measures being imposed by China and the EU; this in effect undermined the confidence in supply chains and a number of companies relocated their operations in the face of increased costs of production and a corresponding shift in demand.

There are rising concerns in respect of the indebtedness of Chinese and Italian banks and the pace of borrowing by the Italian Government has raised concerns over a possible financial crisis in the EU. Meanwhile German manufacturing production growth has experienced a slowdown from 1.9% in 2018 to 1.2% in 2019 (as compared with 1.5% in 2018 and 1.4% in 2019 for the UK). A similar trend is seen in China, where expected growth was reduced from 6.6% in 2018 to an estimate of "between 6 to 6.5%

in 2019" – the weakest performance of China in three decades. However, a similar trend is commonly observed in economies driven by industrialisation when demand for exports decrease.

In the past, most growth in the UK was generated by workers from EU Member States. This trend has now disappeared and this is likely caused by Brexit which has aggravated skill shortages in a tough labour market. Real earnings are recovering in the UK whilst inflation is falling, thus supporting an economy which largely depends on consumer spending. Future growth in the UK will ultimately depend on whether a withdrawal agreement is approved, or whether there is a 'no-deal' scenario which is expected to have the most detrimental impact on the UK's growth prospects (0.4% in 2019 and 0.3% in 2020 as opposed to 1.5% in 2019 / 2020 if a withdrawal agreement is approved). The continued uncertainty in respect of Brexit has reduced corporates' risk appetite as emphasis is placed on mitigating the risks stemming out of Brexit. Nonetheless, the UK is a competitive and flexible economy and is expected to adapt well in the long term.

Session 2: US and European Loan Markets: Trends and Insights

Since the financial crisis, the US loan market has experienced strong growth. 2018 was a particularly strong year for the US market, with loan outstanding's totalling $1.5 trillion and 2019 expected to remain stable. Loan default rates also remained at historically low levels of around 1.75%. For the European loan market, volumes had increased from 2017 with 2018 loan issuance totalling $865 billion.

Despite strong overall growth, loan markets in both the US and Europe struggled in Q4 2018 and borrowers were more cautious. The high yield bond market dried up in Q4 2018 and investment grade bonds were at their lowest since 1995. Despite these trends, the share of new money deals managed to increase from 37% in 2017 to 53% in 2018.

In terms of documentation trends, since 2016 there has been a gradual loosening of documentation from a lenders perspective. For example, EBITDA adjustments have become looser with 20% and 42% of deals signed containing uncapped EDITDA adjustments in Q4 2018 in the European and US loan markets respectively.

Covenant lite loan agreements continue to dominate the market in both Europe and the US. In Q4 2018, 73% and 92% of deals were 'cov-lite' in Europe and the US respectively. Additionally, the market has been behaving in a borrower friendly manner with respect to incremental debt. In recent times, incremental facilitates have been heavily negotiated, in particular in respect of how big the incremental facility can be. Furthermore, Most Favoured Nation (MFN) sunset provisions have significantly weakened in Europe. For example, the average MFN rate in Europe was 96.67 bps in Q4 of 2018 compared to 55.73 bps in the US.

A recent case involving Windsteam Holdings Inc put a spot light on net short debt activism, whereby activist investors who own more credit default swaps than debt use their debt portions to push for a default. This has raised concerns amongst borrowers that distressed debt funds could buy credit default swaps and then manufacture defaults on the debt to make a profit.

In the secondary loan space, annual trade volume totalled $720 billion in 2018 in the US. Liquidity is critical for a vibrant secondary loan market. In terms of transferability, the number of deals including white lists has increased, with 73% of deals in Europe containing white lists in 2017 and 91% in 2018. Traditionally, borrowers consent was disapplied when the loan went into default but this has weakened in recent years. Recent deals have also seen restrictions in relation to transfers to 'loan to earning' investors and vulture funds. In these cases, investors normally turn to indirect forms of sale, such as sub-participation agreements, however these are also increasingly being restricted.

Session 3: Fireside chat with Direct Lenders – What's On Their Minds

The lending market is much broader than just banks. In recent years, the number of direct lenders has grown dramatically in the US and in Europe (although the market is more established in the US). Direct lending players come in various forms including but not limited to alternative asset managers, business development companies, finance companies and debt fund affiliates of private funds. Typically returns for direct lenders are higher than for liquid loans and investors in direct lenders gain access to those returns that are not available in liquid markets.

The competitive advantages of direct lenders over traditional banks include not being subject to the same regulatory requirements, such as the leveraged lending guidance in the US. In the case of Brexit, direct lenders tend to thrive in situations of uncertainty. They have the capacity to take on more highly leveraged deals and complex funding structures. Direct lenders also face no syndication requirements, which allows for faster execution. Through this, they are also able to obtain a more consistent lender-borrower relationship. Direct lending does come with its own set of risks including securing the right capital and pursuing the right capital strategy, ensuring no mismatch between assets and liabilities and finding appropriate legal representation.

Direct lenders tend to have a symbiotic relationship with bank lenders as banks provide financing to, and underwrite issuances by, direct lenders. Recently direct lenders have found that certain sectors are seeing more distress, including the automotive sector.

Session 4: Green Lending: Has The Moment Arrived?

During the course of 2018, green lending increased dramatically. Global green and sustainability-linked/ESG-indexed loan issuance totalled $58 billion in EMEA, $11 billion for Asia Pacific and $8 billion in the US in 2018. Europe is leading the way in sustainable finance, with Spain, France and the Netherlands being the most supportive of global green and sustainability-linked/ESG-indexed loans. The US green lending market has tended to lag behind due to a number of factors including a lack of regulatory and political support compared to Europe. The Green Loan Principles (GLP) have been instrumental in leading the market towards best practices and in promoting consistency across financial markets.

In terms of sectors, renewables and real estate have demonstrated the most potential for growth in green lending. In 2018, Triton Knoll wind farm secured £2bn of lending which is one of the largest renewable operations reported to date. Similarly, EDF secured a €4bn sustainability linked refinancing. The panel predicted that green lending would start to increase in the US as renewable energy gains in popularity. In the leveraged market, investors are developing an interest in ESG-related due diligence and are including ESG considerations in their credit review. Sustainability-linked loans are flexible in terms of use of proceeds in comparison to green bonds and green loans and are therefore attractive to borrowers. To date almost one third of green lending has been provided to financial institutions and confidence is growing amongst a range of non-bank lenders, including in private placements.

Regulatory input from the European Parliament is expected to facilitate green lending with capital impact granted in the form of brown capital charges and/or green capital relief. The internationally-recognised Principles for Responsible Investment is gathering signatories to demonstrate the market's commitment to responsible investment. League tables continue to have some effect on shaping the market.

Session 5: Brexit and Beyond

The panel focused on the anticipated timelines, potential outcomes, and issues affecting financial services and the loan market in particular, including contingency planning in respect of the UK's withdrawal from the EU.

In terms of timelines, the political outcome is still unclear, but financial institutions have already had to implement their contingency plans. Whether there is a hard Brexit or not is a bit of a red herring. The key issue is whether there will be a transition period or not. In any case, UK institutions will not enjoy the same level of access to financial services across the EU27 post- Brexit.

The panel recapped the various ways that financial institutions had previously organized their European business, often with London as a hub. The panel emphasized the complexity of the contingency planning that financial institutions have had to undergo, considering their individual footprints and the various ways in which the regulation of different financial products will be affected by the loss of passporting. Unlike other products which are regulated on an EU-wide basis, the loan market has to consider the requirements of each individual member state in which it operates, including requirements related to tax and capital. Contingency planning has involved a host of technical, legal and practical considerations, not the least of which are on the operational side. The panel emphasized that it has required an enormous diligence effort, both with respect to legacy businesses as well as for the handling of new business going forward. There is no 'one size fits all' approach and preparations of every firm have differed depending on its existing regulatory footprint, geographical location, types of asset classes and perhaps future strategy.

The panel took a look forward to discuss what challenges may lie ahead post-Brexit as the new arrangements are implemented by financial institutions across the market. Whilst the UK is providing transitional relief to permit EU27 firms to conduct business in the UK for 3 years, the EU has not chosen to do so. This raises operational challenges for firms seeking to maintain access to the Single Market.

Whilst majority of institutions have made their preparations, it is anticipated that hand holding will be required post-Brexit as the market adjusts to the new arrangements and the practicalities of the regulatory reality.

Session 6: 2019 Geopolitical Trends: What's Next for the Loan Market…and the World?

The trend of political turmoil is likely to continue around the world. Populist political upheaval is on the rise and it is expected to continue in the years ahead. There has been a substantial erosion of trust in governmental institutions around the world. The populist discourse in Europe is driven by states which are concerned with immigration, and those driven by economic concerns. The upcoming elections in Finland, Denmark and Poland, as well as the elections upcoming in Tunisia will test the viability of populist convictions associated with immigration. It is interesting that the threat of a nuclear war between India and Pakistan looms on, however recent tensions between both states barely appeared on the front pages of newspapers.

There are upcoming elections in India, where the government has deployed several populist measures to appeal to the electoral, depict how the mistrust in government and institutions can generate new policies that have a direct impact on businesses. The issue of underfunded pensions in the US is highly prone to the populist discourse which in turn raises political agendas to change regulations such as taxation. Meanwhile issues such as those related to infrastructure, financial services (such as the increased attention towards CLOs and the potential ramifications of the discontinuation of LIBOR) are all examples of issues that can be manipulated to fuel the populist agenda, especially if they have a direct impact on individuals or if they can be framed as such.

Whilst we had seen the re-emergence of the debate concerning the benefits of international trade, most people in the world's economically most developed countries are still favourable to trade and this number has increased over the past four years. However, the debate is much more nuanced, and the benefits of international trade must be emphasised in a more tangible manner going forward. There is a likelihood that the US and China will sign a trade deal, meanwhile Trump's claims concerning the withdrawal of the US from NAFTA had not materialised. Nonetheless, several states introduced or enhanced their laws on foreign direct investment (FDI) and there has been a rise in resource nationalism. The scope of protectionism more broadly has expanded from the traditional sectors to the wider economy.

The rising tensions that underpin the relationship of China and the US giving rise to national security concerns impact FDI and M&A activities around the world. China is also behaving in an increasingly more assertive manner on the global arena. Meanwhile China's interests are increasingly aligned to those of Russia which is worrying. Tensions can have a very tangible impact on businesses as private entities have increasingly felt the impact of political forces. Long term damage is being caused by imposing tariffs on allies. There has been an increase in state-sponsored cyber-attacks on private entities and companies being targeted in foreign policy disputes. Finally, Brexit has overshadowed other issues in the UK, although this is part of a bigger issue.

Session 7: Quantum Computing and the Loan Market – What You Need to Know

Quantum computing is an impressive emerging technology that is likely to impact the loan space within the next 5 years. Quantum mechanics, the fundamental theory behind it, dates back 100 years and describes phenomena which classical physics cannot account for. The potential of quantum computing kicked-off in the 1960s with the idea that information could be represented as a physical entity to be manipulated according to the laws of physics. Over time, exotic phenomena such as quantum entanglement have been incorporated in quantum computing in order to increase processing power. Quantum entanglement, when pairs of particles interact in ways in which each particle cannot be described independently from the other, pose great opportunities in the future of quantum computing.

In order to leverage the potential of quantum computing at a business level, there are some intellectual and practical stepping stones that need to be crossed. Although researchers have discovered many quantum algorithms that could potentially solve optimisation problems exponentially faster, it remains difficult to convert those abstract algorithms into actual quantum circuits. Another challenge is the current immaturity of the quantum processor hardware, given that millions of qubits are required to handle real world data sets, yet actual quantum processors currently have only ten of qubits. Banks are encouraged to gain an understanding of this technology and find out what their peers are doing; this will help prepare for the time when sufficiently powerful quantum computers become commercially available.

Quantum computing differs to classical computing in that a single quantum processor can explore many different processing routes in parallel and thereby find the optimal solution much faster. However, there are currently significant research challenges, including reducing the occurrence of random errors and increasing the coherence time of the system so that more complex programs can be run.

Quantum computing is expected to be transformational for certain optimisation processes in banking. Consider, for example, that securities settlement often uses netting algorithms to optimise the combination of transactions to settle – and greater processing power would permit more efficient settlement. Modelling portfolio volatility and calculating value at risk also show potential for development in future. However, there is a threat that we should be aware of: quantum computers may be capable in, say 10 years, of cracking the classical cryptography underlying the backbone of banking.

Session 8: LIBOR Lowdown – Developments in Benchmark Replacement

It has been 18 months since Andrew Bailey's speech of 2017 in which the Chief Executive of the UK Financial Conduct Authority had called for a transition away from LIBOR given questions over its long-term sustainability. Whilst initially work had focused primarily on the derivatives market, it had subsequently expanded to also cover cash products. The national working groups across the five LIBOR currencies have identified their respective backward-looking risk-free rates ("RFRs"), which differ from LIBOR both in terms of methodologies and times of publication. As yet, there are no forward-looking term rates based off RFRs.

In 2018/2019, IBA conducted a survey on the use of LIBOR currencies and tenors to identify the most widely used LIBOR settings. IBA intends to help the market to transition to RFRs by facilitating continuity

of certain LIBOR settings post-2021 for users with outstanding LIBOR-linked contracts. Respondents identified USD and Sterling as the most widely used LIBOR currencies (with 1, 3 and 6 months the most commonly used tenors). Further announcements will follow in due course.

In the US, the Alternative Reference Rates Committee ("ARRC") was established by the Fed to ensure a successful transition from US dollar LIBOR to SOFR. The ARRC is comprised of a diverse set of public / private sector entities and the LSTA co-chairs the ARRC Business Loans Working Group. In 2018, the ARRC had consulted on US dollar LIBOR fallback contract language for syndicated loans. This consultation had set out two options: an amendment and hard-wired approach. Whilst responses were mixed, the hard-wired approach is ultimately the preferred option once there is more certainty. The work on fallback language had shed light on the question of spread adjustments given the economic differences between LIBOR and RFRs. The ARRC will now commence work on spread adjustments which are expected to align with the derivatives market to the extent possible.

In the UK, the LMA chairs the sub-group on benchmark transition issues in syndicated loan markets established under the Sterling RFR Working Group. The loans sub-group had recently confirmed that the amendment approach remains the preferred option in EMEA as it is too early to hardwire fallbacks to RFR-derived rates which may not become available in time for the transition or may not be operatively workable. The LMA currently incorporates the amendment approach in its documentation (via the revised replacement of screen rate clause). The loans sub-group is currently working on a market-wide consultation on adjustment spreads. It has been identified that a robust forward-looking term rate could help to facilitate the transition to RFRs in certain segments of the cash market. However, the Sterling RFR Working Group is due to publish a paper on cross-product conventions for referencing SONIA, and there has been recent focus on infrastructure and systems developments. It is important to consider systems issues early on as it may take between 3 to 18 months to build adequate systems.

There had been a good and increasing level of bond issuances referencing SONIA and SOFR, however no syndicated loans using RFRs have been transacted to date. When asked about the likelihood of an RFR-linked syndicated loan being issued, 66% of the audience thought it is 'very likely once RFR-derived rates are further developed', with 27% saying 'never, unless forward-looking term rates are available'.

In the EU, €STR is due to be published by the European Central Bank ("ECB") by October 2019 at the latest. A political agreement has been reached on the extension of the EU Benchmark Regulation transitional period until the end of 2021, bringing the timeline in the EU into line with LIBOR transition. Whilst EURIBOR is intended to continue being published under the new hybrid methodology, EONIA is going to be discontinued and market participants should pay attention to any facility documentation referencing that rate. The Euro Working Group on RFRs continues to focus on the transition from EONIA to €STR. Respondents to the ECB's consultation published in December 2018 favoured recalibrated EONIA (i.e. €STR plus a spread) being published until the end of 2021. A forward-looking term rate based on tradeable OIS quotes was also favoured by market participants as a fallback to EURIBOR.

Given the need for international cooperation, trade associations have held monthly meetings intended to establish regular communication and discuss key issues and developments. The LMA and LSTA also hold fortnightly LIBOR calls.

Session 9: Sanctions – A Political Tool

The decision of President Trump to withdraw from the Joint Comprehensive Plan of Action (JCPOA) on 8 May 2018 has seen US secondary sanctions return on Iranian traded goods. Primary sanctions, economic sanctions imposed by OFAC that require "US Persons" to abide by sanctioning rules, will not be affected by the withdrawal. The sectors that are likely to be most affected by secondary sanctions are automotive, metals and oils. The US will also extend its list of Iranian Specially Designated Nationals and Blocked Persons (SDNs). INSTEX, Instrument in Support of Trade Exchanges, has been set up to help countries continue to do business with Iran despite the secondary sanctions imposed by the US. This is set up as an SPV which is going to help facilitate investment into Iran. The US has made aggressive statements on this development and it is not clear as to what impact this will have on the market.

The US has also imposed sectoral sanctions on the government of Venezuela, which impose new debt restrictions. Although these are a granular set of measures with most business practices being able to continue as normal, there are some restrictions on bonds, debt and general licenses that may pose problems. The US have put PDVSA, a Venezuelan state-owned oil and natural gas company, on an SDN list which is seen as a draconian measure, impacting a lot of deals.

In the EU, the EU Blocking Regulation was updated on 7 August 2018 and has led to issues in respect of documentation. There is no silver bullet for documentation in this respect.

Parties are developing their own internal policies on how they deal best with Iran and North Korea. This is causing problems for large syndicates that have a variety of different internal policies. In terms of documentation, it is encouraged that clients have the most up to date covenants. With respect to due diligence, this will vary depending on transactions. For example, an oil related transaction in Iran will require more due diligence than a similar transaction in Norway. To the extent that sanctions prevent a deal from closing, parties should seek to pursue a license from OFAC if necessary.

Session 10: Competition Enforcement – Keeping the Markets Fair & Efficient

There has been increased attention paid by competition law regulators in respect of syndicated lending. The UK Competition Market Authority and the Financial Conduct Authority both take their roles as enforcers of competition law very seriously and both have proven to be ambitious to have the "top seat at the table of competition law agencies world-wide". In fact, enforcement activities by both regulators can be said to be driven by these factors, particularly with respect to financial services given the UK's prominent role in the regulation of financial services. In respect of the EU regulators, it is uncertain whether the EU Commission will discontinue UK-related investigations in the event of a "no-deal" Brexit.

In February 2019, the FCA issued its first anti-trust enforcement case in which the infringements consisted of the sharing of strategic information, on a bilateral basis, between competing asset management firms during one initial public offering and one placing, shortly before the share prices were set. The firms disclosed and/or accepted otherwise confidential bidding intentions, in the form of the price they were willing to pay and sometimes the volume they wished to acquire. This allowed one firm to know another's plans during the IPO or placing process when they should have been competing. This case constituted the FCA's first competition law decision and sets a precedent for future cases on the FCA's approach in respect of exchange of information (where the threshold that gives rise to liability is particularly low, i.e. mere passive acceptance of information was deemed sufficient). Pursuant to the FCA Statement of Objections in 2017, the regulator is looking to prevent illegitimate conversations. It is expected that the FCA's approach to competition issues will evolve significantly in the future, especially considering its enhanced powers under the Competition Act and Financial Services and Markets Act which provide it with the ability to investigate firms' activities closer than any other financial services regulator in the world.

The syndication process (and post syndication activities) can raise unique competition law related issues for financial institutions to consider, including those related to information exchanges / coordination during the early stages of a syndication process, primary allocations, as well as hung deals and sell downs. In previous years, the EU Commission commenced investigations in respect of six EU Member States as it believed that the opacity of the syndicated lending market suggests that anti-competitive behaviour could be taking place. Scandals related to the manipulation of LIBOR have also driven the attention of regulators to investigate financial services. A number of banks have since reviewed their internal policies and conduct in syndication practices which has lead to the conclusion that these would not withstand the strictest test of competition law. There is now an investigation into how banks handle their positions after syndications for a variety of financial products and not just loans. The basic rule of competition law is that regulators are not favourable towards coordination between market participants. Coordination is generally only permitted insofar as it is necessary in a given market. The peculiarity of syndication is that it allows for certain discussions to take place in order to benefit the borrowers by setting a good price for the loan. To pass a so-called 'strict test', coordination must be the minimum of what is required to achieve such efficiency benefit in syndicated lending.

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