<u>Loan Operations Conference</u>

6 June 2019

One Bishop Square, London, E1 6AD

<u>Introduction</u>

On 6 June 2018, the Loan Market Association ("**LMA**") held its flagship European Loan Operations Conference at One Bishops Square, London. As always, this event was extremely popular and the LMA was delighted to see over 200 market participants and speakers in attendance. The conference touched on a range of hot topics, including KYC and LIBOR, as well as covered the key operational issues such as secondary settlement and primary completion.

Loan Operations Committee Introduction

Over the past year, the Loan Servicing sub-committee has focused on producing educational pieces for the market. In Q2 of this year, the committee published a guide entitled *Factors for Consideration in Lending Transactions – Completions and Primary Syndications.* This guide seeks to explore the key challenges a facility agent may come across in the completion of a transaction and aims to streamline the completion process and improve secondary liquidity. The sub-committee has also supplemented its desktop series. The series aims to act as operational guides for teams to refer to when carrying out their day-to-day activities in the hope that this will lead to fewer delays and greater daily efficiencies. Following the results of a survey taken at the 2018 LMA Loan Operations Conference, the Loan Servicing Committee have produced three more guides which focus on: *repayments*; *drawdowns* and *rollovers*. In addition, the Loan Servicing Committee will be looking to produce a lifeline of a loan timeline which will eventually be turned into an interactive timeline, potentially utilising the e-learning platform.

The Agency sub-committee has continued to meet on a quarterly basis to discuss a range of issues. These are mainly documentation related and focus on the impact on agency teams across EMEA. Key ongoing challenges for agency teams relate to the potential discontinuation of LIBOR and transition to risk-free reference rates across the relevant jurisdictions, as well as dealing with operational delays attributable to Know Your Customer ("**KYC**") obligations.

The Secondary sub-committee has been focusing on identifying impediments to settlement, both in the primary and secondary markets. Recently the secondary sub-committee has been meeting with the buyside sub-committee to tackle those issues.

Trends in the European Market

In 2019, activity in the syndicated loan market has been lower by 30% than during this time in 2018. Specifically, leveraged loan volumes are at €27 billion in contrast to €40 billion last year. The supply/demand imbalance continues with resurgent CLO new issuance up by 10%.

There have been significantly fewer jumbo deals in the market. Whilst some large deals have closed with the likes of IFCO and Nestle, in 2019 the majority of deals have ranged been between €100 to €500 million.

In terms of documentation, default and collateral protection have declined significantly in Europe over the past couple of years. In recent times, there has been a trend towards US-style documentation that contains fewer lender protections. Paradoxically, and in contrast to the US, transferability restrictions in European deals have become tighter even as the documentation has become looser.

LMA Completions guide – Operations Challenges to Transition

The primary syndication process comprises a number of key participants often dealing with multiple competing priorities which can complicate and frustrate the syndication process. To reduce the detrimental effects of this, the Loan Servicing Sub-Committee prepared a guide which seeks to explore the completion and primary syndication process in more detail. From an operational perspective, there are a number of pitfalls that the agent can fall into. A survey taken by market participants who attended the conference showed that 48% of these are caused by poor communication between the different departments.

The guide also starts with the assumption that poor communication is one of the key factors that contributes to inefficiencies on deals. Effective communication between all parties to a deal is paramount to facilitate the effective and efficient completion of those deals. The guide proceeds on the assumption that if all parties to a deal are aware of these risks and how to mitigate them from the outset of any given transaction, including timelines and completion mechanics, this would enhance the progress made with respect to the transactions at hand; from mandate to the deal going live and being fully funded. This is especially true given a lot of manual work is involved on the part of banks.

Furthermore, the guide explains the roles of some of the key participants to a deal, including those of the agents, advisors, sponsors, borrowers, lenders, lead arrangers, underwriters and fronting banks. Awareness of each other's role at each stage in the process is also a key efficiency driver. The guide is now available on the LMA website here.

Analysing the Timeline

The Secondary sub-committee, in collaboration with the Buyside sub-committee, has been working to identity the bottlenecks in the settlement process, with the aim of tackling delays by driving behavioural change. Whilst settlement has improved and the Q1 2019 statistics stand at T+27.7 for par trades and T+44.6 for distressed trades, there is nonetheless a large discrepancy between transactions being processed across different trading houses.

Using settlement milestone data supplied by IHS Markit we can see where, on average, notable delays occur in the process from trade date to cash settlement. One such delay is the time it takes to agree the trade confirmation. The LMA has produced a recommended form of trade recap where any non-standard terms should be highlighted, as indeed they should be at the time of the trade itself. It is hoped this recap will reduce the need to negotiate the trade confirm.

Another bottleneck would appear to sit with the agent, partially down to KYC obligations. In the context of UK-based agents, it is believed that once HMT sign off on the JMLSG guidelines, timing with respect to KYC processing can be improved.

LIBOR transition – the operations perspective

Note that a recording of this session is available on the LMA website here.

It has been nearly two years since Andrew Bailey's speech of July 2017 in which the Chief Executive of the UK Financial Conduct Authority ("**FCA**") called for a transition away from LIBOR given questions over its long-term sustainability. The audience were asked whether the transition from LIBOR to alternative near risk-free reference rates ("**RFRs**") is a big challenge for the syndicated loan market; 46% of respondents saw it as the biggest change the market has ever experienced, 34% thought it was a big change which the market can manage, whereas 19% either did not understand the issues or did not have any knowledge with respect to RFRs. It was explained that the transition is a fundamental change for the loan market and presents significant commercial, operational and documentation challenges.

National working groups across the five LIBOR currencies have identified their respective RFRs, which differ from LIBOR in certain key respects. The RFRs are published at different times from each other (given they are administered locally), in contrast to LIBOR which is available as of 11:00am for each LIBOR currency. The RFRs are also backward-looking overnight rates which do not contain a credit premium nor a term liquidity premium. As a result, in most cases RFRs are lower than their LIBOR equivalents. It is important to note that LIBOR increases in periods of credit stress, whereas the RFRs would remain flat or may decline (given they are not reflective of bank credit risk).

There are several ways in which RFRs could be referenced in cash products. These are highlighted in more detail in a number of official publications (including the Discussion Paper on Conventions for referencing SONIA in new contracts and the Financial Stability Board's User Guide on Overnight RFRs). None of these options are, as yet, operationally viable and require updates to systems. Whilst RFRs could technically be aggregated or averaged today to derive term interest payable, as yet there are no screen rates or calculators available to verify these calculations and so to do this would currently be a manual process. As yet, there are no forward-looking term rates based on RFRs. Each of the national working groups, except for the Swiss working group, are working on developing such forward-looking term rates. However, the development of these is dependent on liquidity in the underlying derivatives market and the availability of the relevant data on electronic trading platforms.

The transition to RFRs will have a big impact on loan operations teams. The following areas were discussed: syndicate agency; infrastructure; processing; borrowers; documentation; operations colleagues; communications; and internal relationship management. In relation to impact on infrastructure, it was noted that lead times to develop and deploy the necessary systems can be lengthy (ranging from 3 to 18 months depending on what the ask is). As a result, decisions will need to be made soon to ensure readiness by the end of 2021. When asked whether they were in dialogue with their loan system providers with respect to the transition, 66% of the audience answered that they were in early stages of dialogue given the uncertainty re the rates the market is moving to, 31% said they were not in dialogue, whereas 3% were clear about the system updates that their organisations required.

With respect to processing-related issues, a number of operational issues must be considered, including those arising from operational compression, considerations related to the potential dual running of LIBOR, EURIBOR and RFRs in deals across the market, as well as potential consequences arising from calculation of withholding tax and how to deal with loan breaks and trades, to name a few. Another key issue is communication, both internally within lending institutions and also to borrowers. Borrowers needed to be made aware of the transition and alternatives discussed with them. Relationship managers also need to be made aware of the transition and its impacts so they can discuss this with borrowers.

In terms of documentation, consideration needs to be given both to new documentation being entered into and also to legacy documentation referencing LIBOR. In terms of new documentation, the LMA is in the process of working on a draft facility agreement based on compounded RFRs in arrears (in the absence of a forward-looking term rate). Where new deals are still being based on LIBOR, then parties need to consider the LMA revised replacement of screen rate clause (published in May 2018). In May 2019, the ARRC published its recommended contractual fallback language for USD syndicated loans which recommends two alternative fallback approaches: the hardwired approach and the amendment approach. The amendment approach is similar to that used in EMEA (i.e. the LMA revised replacement of screen rate clause). The hardwired approach has not been used to date in either the US or EMEA. In relation to legacy documents, there is no ISDA style protocol available to amend legacy documents en masse. However, the LMA is working on a form of agreement which can help to transition legacy transactions more efficiently. It is important to remember that as well as an amendment agreement for each deal, parties will need to factor in the need for conditions precedent, including legal opinions and also any impact on security.

Given that the end of 2021 is not so far away in light of how much there is to do to prepare for the transition, the audience were encouraged to come to decisions as to the basis on which interest going forward should be calculated on, communicate with infrastructure providers, borrowers and colleagues, as well as respond to relevant market consultations to drive any market solutions. All loan market participants will be impacted by the transition to RFRs and there is much work to be done in a short space of time. Therefore everyone needs to be up to speed with developments.

Click here to view the LMA LIBOR Microsite for more information on LIBOR transition.

Solving for KYC

The syndicated loan market has seen significantly increased levels of customer due diligence, requiring firms to identify the customer and any beneficial owner, assess the intended nature of the business relationship and conduct ongoing monitoring.

The LMA played an instrumental role in re-writing Chapter 17 of the JMLSG Guidance which relates to syndicated lending. The LMA's efforts were a result of extensive communication with its members, including representatives of the LMA's Loan Operations Committee. Since the revision, the LMA has been involved in meetings with the FCA and HMT to explain the approach of the guidance and outline ongoing issues. HMT have requested very few changes as a result of the chapter 17 revision.

As an example of how the secondary market should be positively impacted, the revised guidance states that, although the agent has a role to play with regard to effecting the transfer of loan commitments from a seller to buyer, it will not have a "customer" relationship as such with any buyer, effectively removing the requirement to conduct KYC.

The guidance stipulates that the "customer" relationship is between the lender and the borrower and due diligence must be conducted accordingly. In relation to reliance provisions (i.e. institutions relying on borrower KYC already undertaken by the agent/MLAs), there is a requirement to be able to obtain all information needed from a third party being relied upon. "Arrangements" must be established with the third party to enable it to obtain identification and verification documentation on request, and require the retention of copies. There is some discussion as to whether agents could act as third parties for reliance purposes (especially for buyers in secondary who not have direct access to KYC information), however agents are reluctant to take on this role.

The European Commission's legislative proposal for MLD5 reopened a number of key commercial issues for the syndicated loan market. This includes more stringent requirements regarding access to beneficial ownership which could be challenging from the perspective of security trusts and security trustees.

The processes with respect to KYC obligations differ in the US, where these obligations require key details only, can be dependent on credit scoring and can be tax related.

Agency matters

As a significant proportion of syndicated loans mature after the end of 2021, LIBOR is a key challenge from an agency perspective. The amendment process with respect to outstanding legacy deals is expected to impose significant resourcing and timing pressures on smaller agency teams. Vendor solutions will have an important role to play, however market adoption and implementation of these is expected to take place at a varying pace, which poses additional problems for agents.

With regard to Chapter 17 of the JMLSG guidelines, market participants' adoption of the revised guidance continues to proceed at different pace based on each firm's assessment of how to achieve compliance with Chapter 17. This is a work in progress and HMT ratification will assist.

In Europe, there is no impetus driving the market towards the standard adoption of identifiers, whereas in the US, approximately 90% of loans do incorporate various forms of identifiers such as CUSIP. Identifiers are key to unlocking the full potential benefits of automation and participants are encouraged to co-operate in their application.

The trend of increased offshoring of agency roles has had both positive and negative effects. On the one hand, this process had enabled firms to focus on operational aspect of work which is process driven, on the other hand it is more difficult to train and retain talent in offshore locations. A recent trend in the agency job market shows that employees are far more mobile today than they were in the past and it is increasingly harder to keep experienced agents in their respective roles for long periods of time. This suggests that improvements need to be made to agent's quality of work by using technology to streamline those processes which can be replaced by automation, whilst allowing humans to focus on the most challenging tasks. Nonetheless, the lack of use of identifiers – a key step forward in order to facilitate greater automation in the market – continues to inhibit this process. With time, agents' roles are expected to change, and as a result agency teams may become smaller or become able to scale up and create more volume. The market now needs to decide whether it wishes to continue using bespoke practices, or whether to embrace greater automation.

FinTech accelerating change

On 23 May 2019, the LMA hosted its first FinTech Conference. Prior to the conference, the LMA conducted a survey amongst its members to better understand how they are using, or planning to adopt, new financial technology, and the challenges they are facing as part of this process. The results demonstrate that the most significant challenge for operations teams are inefficient practices. There is a significant lack of realisation of the potential offered by automation as a large proportion of the market is still reliant on traditional practices to conduct their business. Whilst the majority of respondents believed that technology can be positively disruptive in terms of increasing operational efficiencies, the biggest obstacle to adopting of new technologies in the market is the interoperability of scale as platforms across different firms may not be compatible with one another. Nonetheless, awareness has been on the rise with respect to the benefits offered by technology and the loan market had seen an increased dialogue in this respect.

In the future, it is expected that there will be plenty of transformation in the loan operations space, especially through automation of repetitive processes. When asked how the focus on operational efficiency (in ops/agency) has changed in conference participants' respective institutions over the last 2-3 years, 68% of respondents answered that it has increased (either significantly to the extent that it is today one of the key performance indicators (29%), or that it is now high up the agenda (39%)). However, the lack of consistent and effective dialogue between market participants and vendors hampers the progress that could be made. For example, solutions from HIS Markit such as notice manager or loan reconciliation have been in existence for over a decade, however a large number of firms are only starting to enquire about these now. The market as a whole needs to be more proactive in taking steps to improve its processes – the most effective ways being market-wide dialogue between market participants and vendors. Ultimately, development of appropriate tech solutions is driven by client feedback and is based on demand. If the market is to move forward, institutions need to talk to one another and come up with solutions that help to streamline processes across institutions, and not just internally without a more prevalent impact. It can be counter-productive when different market participants build internal solutions which are not compatible with the processes used by any other institution.

The role of humans is not expected to change significantly, albeit technology is expected to improve the quality of work in operations by streamlining mundane processes, generating more time for human input from an advisory perspective.

When asked about their anticipated level of automation within secondary, ops and agency in 5 years, 55% of respondents answered there will be significantly increased level of automation but layers of sophistication will persist, meanwhile only 25% thought that integrated technological solutions will have broad market adoption. Whilst these results show we are not yet there in terms of full appreciation of technology, the market is heading in the right direction.