



LMA & LSTA Conference Summary (11 March 2020)

Global Economic outlook

The global economy underwent a turbulent period during 2019. This was the result of a multitude of factors that range from trade tensions between the US and China, uncertainty surrounding Brexit, rising debt, negative rates, credit risk and finally the emergence of Coronavirus (**covid19**). Tensions are at breaking point and disruptions to supply chains across the world remain as prevalent as ever.

There had been a high amount of fiscal stimulus, combined with low interest rates and around \$14 trillion of quantitative easing, which made up approximately 17.5% of global output. Despite this, banks have still not repaid their bailouts, so the question remains, is policy working? If policy has worked then why haven't economic conditions and financial markets returned to "normal"? This is especially prevalent when shocks are occurring with more frequency, markets are skittish and rates are too low to cut much further to solve the issues at hand. All of these factors mean there is higher corporate vulnerability to a downturn.

Only a third of the cost attributed to covid19 are likely to be direct, with the remainder being indirect due to the high levels of uncertainty and low confidence. The expected growth levels for 2020 were predicted to be a quarter to half of a percentage lower than previously anticipated as a result of the virus, with the recovery only likely to happen in the second half of the year. The spending delayed by covid19 will likely come back once the pandemic is over.

Despite the high levels of global spending, uncertainty has reached record highs, especially around trade. This has hammered business confidence, resulting in lower levels of investment and business expenditure. There has been a worldwide slowdown in industrial production with the three-month moving average having fallen in 2019 for major manufacturing nations including the US, China, Germany, Japan and the Euro Area (as a whole). Despite this negativity, consumer confidence remains upbeat and employment levels globally are still high. As a result, the services industry remained robust..

The trade war between the US and China has had a negative impact for all countries, and has led to slower growth for the most developed countries. Unlike the trade war, Brexit is largely an issue for the UK, with a trade agreement between the EU and the UK being no replacement for a customs union.

The rising global population will create increased strain on climate change, making it harder to keep the temperature rise under control. China's population is expected to rise by 2% from 2010 to 2050, which is especially poignant considering their living standards rank 73rd in world, making it even more difficult for them to combat the climate emergency.

UK & US loan markets: Trends & Deal Terms

The Federal Reserve had cut their rates by 50 basis points, whilst the yield on US Treasury Bonds had fallen, proving that people were still willing to lend to the US Government. The effect on the loan market was an overall pull-back, with a lower number of opportunistic financings, rating downgrades and a general movement from term loan B to A. Two days prior to the conference, the market had experienced its biggest drop since 2008.

Covid19 has had a major effect on Europe, with covid19 having had its worst effect on Italy at the time of this Conference. The UK was tipped to be around 8 to 10 days behind Italy in relation to the impact of covid19, and the economy had yet to feel any considerable strain from the virus. With the majority of the US leveraged market being based domestically, they had yet to face the consequences of covid19, but it is likely to have a greater effect on US firms than expected. This brings about the importance of evaluating the solidarity of the companies being lent to.

Despite 2019 being a strong year, issuance still fell, with institutional issuance being hit the hardest and falling by 45%. Refinanced dominated the EMEA leveraged market, with the market experiencing lower levels of issuance than 2018, notably lower levels of M&A and few large deals. Despite these lower numbers, there was a high volume of refinancing in the last quarter of 2019, and generally high volumes throughout the start of 2020.

The European market has seen many add-backs to EBITDA come into deals, among a very "borrower friendly" market, with little opportunity for push back on deal terms. European and US markets had seen no fundamental change to the flexibility of deals. Market push-back has been lower and there has been more collateral leakage..

The direct lending market continues to grow, with the definition continually evolving from its initial "shadow banking" days. The desire for debt has pushed direct lending higher up on the agenda, providing a more direct engagement, and so a more tailored package between the borrower and the lender. Direct lending deals are more likely to be covenant-lite. These are predicted to become more prevalent over the subsequent months.

Sustainable Financing – Going Mainstream

The green and sustainable loan markets have been ever increasing in size since the first green loan was issued in 2014. The market has seen a yearly increase from this point, more than doubling in 2018 and 2019. At the end of 2014 the market volume sat at \$22.5bn worldwide, compared to 2019, where the market volume has increased by almost ten times to around \$220.2bn. The market as a whole has been driven by EMEA, which accounted for two thirds of the market in 2019, despite volumes in the Americas more than doubling between 2018 and 2019.

There is a strong call for education in the green and sustainability finance markets. Completing a survey circulated prior to this Conference, 50% of respondents stated that they did not know what a sustainability coordinator is, and 40% admitted confusion to the diversification of labels taking place

in this market. As the market becomes better educated, and green and sustainable finance better understood, we will likely see a rise in the number of players looking to engage with green and sustainable finance tools. This is particularly true for SMEs, who have yet to engage as fully as the large investment grade corporates.

Looking at the setting of key performance indicators (**KPIs**), it was stressed that ambitious targets must be set to help drive the market in a positive direction and avoid any accusations of green washing. The sustainability coordinator, where appointed, should play a key role in assisting the borrower in the setting of ambitious KPIs, although it is incumbent on all syndicate lenders to analyse and challenge the KPIs put forward.

Transition finance remains a hot topic of conversation, with 45% of survey respondents believing it is not practical to completely move away from "transitional" investments. Going forward, it will likely become increasingly difficult to finance brown projects. Banks and investors have a key role to play in aiding companies in transition from brown to greener/green practices.

From a documentation perspective, the drafting of additional clauses to adapt the loan to a green or sustainable financing is not believed to be overly complex. There is currently no consensus as to whether a green breach should constitute an event of default, and what impact this would have on the loan – whether it simply be declassified as a green financing or the loan be recalled – so watch this space. There is also debate as to how any margin premium, paid by borrower for failing to meet its KPIs, should be applied, with some lenders feeling uncomfortable to be financially profiting from their borrower's failing to meet green/sustainability targets.

LIBOR - are you ready?

In July 2017, Andrew Bailey, then Chief Executive of the UK Financial Conduct Authority ("FCA"), warned market participants that they should not rely on LIBOR being available after the end of 2021 given questions over its long-term sustainability. 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. The deadline of end-2021 has been reiterated by authorities around the world and even shorter deadlines have been set in some jurisdictions, such as the Sterling RFR Working Group which has set a target of ceasing issuance of cash products linked to sterling LIBOR by end-Q3 2020.

While forward-looking term rates based on RFRs are under development in each currency jurisdiction (aside from Switzerland), none are available as yet. In some jurisdictions, forward-looking term rates may not be available until after end-2021. However, the authorities have been clear that the use of any such forward-looking term rates is to be limited. In the sterling market, whilst a forward-looking term rate is expected to be available by end-2020, the Sterling RFR Working Group has stated that SONIA compounded in arrears is appropriate and operationally achievable for 90% of new loans by value. The focus in the sterling market has therefore been on compounded in arrears structures. In the US, in order to accelerate transition in the first instance, simple SOFR might be a viable option for loans given it might be easier to implement and operationalise, and the market could later switch to compounded SOFR in arrears. In the UK, the regulatory message has been clear around the focus on compounded in arrears and not simple averaging. In addition, in the UK the use of compounding v simple was the subject of a market consultation and the clear market feedback was in favour of compounding given the benefit of aligning the loan market with the derivatives and FRN markets, the reflection of time value of money in the compounded rate and also end user demand.

In terms of the use of RFRs in the loan market, we have seen: SONIA-based bilateral loans and an amendment of a LIBOR loan to SONIA (all of which opted for the compounded in arrears methodology using a five business day lag); bilateral loans based on SARON (the Swiss RFR) compounded; and a bilateral SOFR loan and a bilateral trade finance loan. In the syndicated space, Shell signed a USD LIBOR based loan with an in-built switch to compounded SOFR in arrears at a future date; this used the LMA exposure draft SOFR facility agreement. In addition, BAT is using the same mechanism for its facility whereby LIBOR interest rates for sterling and U.S. dollar will be replaced by SONIA and SOFR respectively.

Whilst consensus is still needed across currencies on key conventions in the loan market in respect of the compounding methodology, there have been positive developments such as the publication by central banks of daily compounded RFR indices which will help borrowers reconcile interest calculations. For example, the Federal Reserve Bank of New York has published a SOFR Index since March 2020 and the Bank of England will begin publishing a SONIA compounded index from end July 2020. Work is continuing in terms of how such indices can be utilised in the loan market. Connected to this is the outstanding work on building loan and treasury management systems which facilitate loan transactions based on compounding in arrears.

Given the lack of market practice in relation to RFR based loans and the need for agreement on the key compounding conventions, work has been on-going in respect of loan documentation for new RFR-referencing transactions. For example, the LSTA has circulated to members a draft “concept credit agreement” for a term loan referencing compounded SOFR in arrears. A simple SOFR in arrears version is also being progressed. Meanwhile the LMA has published two exposure draft facility agreements based on compounded in arrears – a SONIA-based sterling facility and a SOFR-based U.S. dollar facility, as well as an exposure draft reference rate selection agreement to assist with the transition of legacy syndicated agreements based on LIBOR to RFRs. The LMA is also currently working on producing an exposure draft of a multicurrency combined term rate / compounded rate facilities agreements.

In respect of fallback language for existing documentation, the LSTA is working on updating the fallback language for the hardwired and amendment approach for loans (whilst highlighting the complications arising in the US context when using the amendment approach). The LMA is also starting to see calls in the loan market for a more hardwired approach and is consulting its LIBOR Working Party looking at producing wording for a hardwired / switch mechanism approach for inclusion in its documentation.

Looking ahead, transition away from LIBOR needs to happen by end-2021. It is therefore important for loan market participants to remain focused on the task ahead. Decisions need to start being made as to what rates to move to, the applicable conventions and work carried out with system providers to ensure the necessary systems are in place.

Fintech - revolutionary or evolutionary?

Interest in technology, designed to improve efficiency, transparency and liquidity within the syndicated loan market, is at an all-time high. In the context of a product that has historically been associated with manual processes, the development and implementation of fintech solutions – ranging between blockchain, machine learning, smart contracts and data analytics – could be at most, revolutionary, or at the very least, a strong indication that the market is embracing the need for greater automation of processes. This session discussed the key trends in the syndicated loan market

in respect of the acceleration of fintech solutions in the syndicated loan market and what market participants should be doing to benefit from these developments.

It is widely acknowledged that Fintech has the potential to remove operational frictions and improve efficiencies in the syndicated loan market, for example, by the use of artificial intelligence ("AI") and blockchain, either of which can be used as tools to speed up processes if properly implemented across the wider market. The introduction of fintech solutions as a trend is also underpinned by continuous institutional learning and development in respect of how it can be used across the different business areas. Nonetheless, market-wide adoption of fintech solutions can be characterised as rather slow in the loan market. This is because the financial institutions of today operate in burdensome yet uncertain regulatory environments, both in terms of rising regulatory requirements and increasing willingness of regulators to impose fines on institutions, resulting in the adoption of conservative approaches towards risk mitigation, which vary per institution and the jurisdiction in which they operate. The legal and regulatory challenges with respect to new technologies are product specific, however the risks arising from potential new liabilities and regulatory issues increase every time a new technology is incorporated into a company's business. As banks operate under strict internal and external compliance regimes, this can significantly hamper and delay the process of innovation, collaboration and implementation of fintech solutions – all of which are needed to meaningfully deploy fintech across the market.

Whilst fintech start-ups increasingly offer competitive solutions, it can be nonetheless a challenging and lengthy process for banks to enter into contracts with fintech start-ups, resulting in a strong preference for developing solutions internally. Indeed, many banks have set up internal teams responsible for such development and implementation across their respective business lines. However, by failing to proactively collaborate with fintech start-ups, financial institutions also lose out on the opportunities that could otherwise arise in the context of increased collaboration with the wider market. Collaboration offers the opportunity for market participants to adopt similar approaches, which in turn can help to increase efficiencies. This is key to solving for market-wide issues given specific problems can only be solved in meaningful ways by adopting solutions on a market-wide scale.

Moreover, given the high volume of data created throughout the course of the syndication process, data analytical tools should also be developed further. The regulators are increasingly being seen to engage with the market in this and other areas to provide guidance and encourage the use of fintech solutions to accelerate the efficiencies and liquidity within the market. This is without doubt a positive development.

Work has also been on-going to automatise documentation in the loan market, with the LMA having entered into a memorandum of understanding with Allen & Overy and Avvoka, outlining the intention to develop a documentation automation platform in respect of certain LMA recommended form documents, as well as other ancillary services. As technology becomes an increasingly prominent feature in our working lives, the market is expected to continue to find new ways to make delivering the loan product more efficiently. Documentation automation is therefore seen as an important step in this process.

Whilst the development and implementation of fintech solutions in the market is on an upwards trajectory, the pace of change to date can only be described as evolutionary as opposed to revolutionary. In order to create meaningful change, market participants must engage in collaboration with one another to solve for key market-wide issues which accelerate change. In particular, in the

future, it is expected that there will be meaningful transformation in the loan operations space, especially through automation of repetitive and manual processes.

Political Outlook (Keynote)

Nation states will always have conflicting interests, with the trade war between the China and the US being a prime example. Despite this there was cautious optimism at the end of 2019, with phase 1 of a trade deal being announced between China and the US. This agreement has effectively stopped the bleeding, with a majority of the main issues to be discussed during the later phases of the deal.

The US political system is slowly becoming more and more divided. Many do not think that the economic benefits have trickled down to the less affluent in society. The political scene is changing, Bernie Sanders declared himself a socialist, which would never have happened 20 or 30 years ago. There is also a large divide on healthcare, with around 50% of US citizens looking for more government regulation on healthcare.

The changing political climate can also be seen in the UK, with many Conservative voters more keen to see government expenditure, whilst 2 out of 3 labour candidates proposed some form of nationalisation.

The transition from LIBOR remains a key issue for the loan market, with this transition unlikely to be seamless, particularly given the prevalent conditions relating to covid19.

There had been an increase in the level of foreign investment review laws in the US. Whilst these laws are very broadly defined, they are likely to slow down deal flow. In conjunction with this, there has been huge discontent around Huawei and their involvement with the 5G project, this had even caused Republicans to suggest nationalisation to be able to compete with Huawei.

Many of the events over the last year had brought forth questions over the merits of globalisation, with events such as the China/US trade war, Brexit and most recently the covid19 pandemic, suggesting that free trade and open borders may not be as positive as previously believed. The German health minister had suggested that coronavirus shows that globalisation may have reached its limit.

Solving for KYC

This session provided an overview of the key US and UK anti-money laundering ("AML") laws which underpin many of the Know Your Customer ("KYC") diligence practices in the financial services industry.

In the US, KYC obligations require financial institutions subject to them to develop and implement a Customer Identification Program ("CIP") which establishes procedures for verifying the identity of each customer that opens a new account, to the extent reasonable and practicable, so that the financial institution can form a reasonable belief that it knows the true identity of each customer. In conjunction with a financial institution's CIP, it should also conduct sanctions screening, including against government watchlists. In October 2018, the LSTA developed a set of guidelines entitled '*Know Your Customer Considerations for Syndicated Lending And Loan Trading*' which outline when (and what) diligence is required for each of the relevant relationships in syndicated lending. The guidelines take into account the minimal risks of money laundering and the financing of terrorism that are

present in the US syndicated lending and loan trading markets. The time spent by banks on KYC tasks is often cited as a reason for settlement delays. This is because certain financial institutions seem to be performing KYC on counterparties that is not actually required under the applicable laws. The LSTA guidelines have helped to shorten loan trading settlement times for those institutions that have adhered to them. To aid with the broader acceptance of the guidelines, the LSTA met with different regulatory agencies in December 2019. As a result, the LSTA is now drafting FAQs that specifically address the unique issues of the US syndicated loan market and hope that these will give the banks the comfort they need to revise internal compliance procedures and adapt them appropriately to the needs of the loan market, in order to reduce KYC obligations as a contributing factor to loan trade settlement delays.

In the UK, 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. Following discussions between the LMA, its members, the JMLSG and HM Treasury, Sector 17 of the JMLSG's guidance on the prevention of money laundering and the financing of terrorism in the UK financial services industry, which relates specifically to syndicated lending and which was re-written by the LMA in May 2018, has been formally approved by HM Treasury. The Guidance is intended to provide a clear description of the primary and secondary syndicated loan markets, an assessment of where the risks are most likely to arise when considering money laundering and terrorist financing, and to explain the different types of relationships that exist between the parties to a syndicated loan transaction and the instances where this will translate into a direct customer relationship between those parties. It also emphasises the generally low risk nature of the market from these perspectives, and sets out the reasons to explain why this is the case. In particular, the approved guidance states that: (i) although a syndicated loan is a tri-partite arrangement from a structural perspective, none of the MLA, the agent or the security trustee should be viewed as having a "customer" relationship with each individual lender in the syndicate; (ii) although the agent has a role to play with regard to effecting the transfer of loan commitments from a seller to a buyer, it should not be seen to have a "customer" relationship with that buyer; and (iii) the extent to which the borrower becomes the "customer" of any buyer in the secondary market will depend on the circumstances (further detail being provided in sector 17.22 (B) of the Guidance). In practice, this should mean that the Agent is not required to undertake KYC in respect of lenders (though the risk profile of the transaction should still be considered on a case by case basis). The LMA continues to work with members of loan operations, agency, sell-side, buy-side and compliance/financial crime to ensure that the guidance is fit for purpose, as well as engaging in dialogue with other jurisdictions to see if JMLSG guidance could be acknowledged or endorsed (given it can be relied on in the UK context only).

ESG Investing

The private nature of the loan market provides a challenge for the integration of ESG criterium into the market. Despite this, the use of ESG had become more widespread in the market, having been used in more credit analysis and more investment focused on ESG ratings.

The concept of incorporating ESG criterium into deals was not new for the market. For this to continue to grow in the market, the investment community had been asking for higher levels of transparency amongst agents.

The LSTA published a questionnaire on ESG due diligence which showed that borrowers were only starting the process of including ESG criteria in the US, unlike in the UK where this had become much more widespread. There had been support by both the buy-side and the investment side for higher inclusion of ESG criteria, this will require an educational process.

Politics and regulatory reform

On 31 January 2020, the UK officially ceased to be a Member State of the European Union. This follows approval by the UK and EU Parliament of the Withdrawal Agreement, which sets out arrangements for the UK's transition out of the EU and during which time, EU law continues to apply in the UK. The EU and the UK have until 31 December 2020, the end of the transition period provided for by the Withdrawal Agreement, to negotiate an agreement on their future relationship. Consequently, this session considered the future relationship between the EU and UK and what form it might take going forward. It was recognised that whilst negotiations are on-going, the EU currently has more bargaining power given the UK is seeking to come to an agreement within a pre-defined timeframe and is keen on ensuring that UK firms have as broad access to the single market as possible. Meanwhile, the EU has consistently noted that complete access to the single market for UK firms will not be the same as that provided for under the passporting regime. Whilst the UK is pursuing a clear strategy in relation to negotiating its future relationship with the EU, any final form of the agreement remains to be seen. If the UK is able to negotiate a complete trade agreement, financial services are likely to be included, however, again – this is likely to differ from the access of UK firms to the single market today.

The UK may also be able to rely on equivalence decisions in areas where EU legislation allows this. These would allow the UK to retain some privileged rights to access the EU market. However, it can be a lengthy process for the EU to issue such decisions, and once issued, the EU retains the discretion to withdraw them. If equivalence is to be relied on by businesses, there is a need to ensure that these are of durable nature.

Nonetheless, as one of the three top financial centres world-wide, the UK legislative framework facilitates an open and accessible market for foreign funds – and London is very much likely to retain its position. A key challenge will be ensuring that the UK follows a clear process of consolidation in respect of its onshored legislation and statutory instruments, so that firms are able to clearly navigate through the UK legislative system. The greatest risk for lenders involves a cliff-edge effect where transfers of funds might no longer be possible due to cases of illegality, and it is key for both the EU and UK to ensure that this does not occur.

In respect of extraterritorial US economic sanctions, President Trump continues to use this as a tool of choice. This trend is expected to continue. Whilst the Trump administration continues to characterise Russian interference in US elections as 'fake news', Congress perceives this as a serious issue and is likely to legislate accordingly in the foreseeable future. Conflicts between sanctions constitute a key issue for cross-border business, however this issue is expected to continue in the near-term.

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