SLAUGHTER AND MAY

Recent trends in loan documentation

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Abstract:
This article looks at recent developments affecting loan documentation. It is designed to help borrowers and their legal advisors with horizon scanning in relation to loan finance. This article considers a number of key developments and their effect on LMA-based loan documentation, including reforms to LIBOR and EURIBOR, negative interest rates, sanctions laws, IFRS 16 and the impact of Brexit.

The LMA's Investment Grade Agreements

A Loan Market Association (LMA) loan agreement is the starting or reference point for the majority of mid to large size English law syndicated lending transactions and forms the basis of this discussion of trends in the credit markets. The widespread adoption of LMA terms over the last two decades has brought benefits to lenders and borrowers, making the documentation process more efficient and enabling the parties to focus on the commercial and more bespoke aspects of the deal.

The LMA's forms of facility agreement for investment grade borrowers (the Investment Grade Agreements) are term and revolving facility agreements that aim to reflect many of the concessions normally achieved by a borrower with an investment grade rating. As the "plain vanilla" agreements among the LMA's primary documents, they are used and adapted for a wide range of circumstances. All of the LMA's primary documents aimed at more specialist sectors of the market use the Investment Grade Agreements as their starting point. Accordingly, it is essential for borrowers of all types, whether or not investment grade, to be familiar with their terms.

The Association of Corporate Treasurers (ACT) is the chartered professional body for the treasury profession. It has worked with the LMA on its primary documentation for investment grade borrowers, including the Investment Grade Agreements, since the project was first conceived. The ACT was part of the working party that put together the Investment Grade Agreements and has continued to work with the LMA ever since. Each time the LMA proposes to amend the Investment Grade Agreements, the ACT is given the opportunity to comment from the borrower's perspective prior to publication. The Investment Grade Agreements remain the only documents in the LMA's library that carry the specific endorsement of a borrower-side organisation.

The ACT Borrower's Guide

The ACT has recently published a new edition of its Borrower's Guide to the LMA's Investment Grade Agreements (the Guide). The Guide, produced for the ACT by Slaughter and May, is now in its 18th year. It was first published shortly after the launch of the LMA's Investment Grade Agreements in 1999. It was designed to raise awareness of the content of the LMA's new primary documentation and to highlight how LMA terms might be approached and negotiated by borrowers.

While the aims and shape of the Guide have remained broadly the same over the years, with each new edition the content has evolved significantly. The Guide has been updated over time to reflect changes to the Investment Grade Agreements prompted by market events and legal and regulatory developments as well as to reflect movements in loan market practice.

All LMA documentation is presented as a starting point for negotiation and, as emphasised in the Guide, borrowers should not be deterred by the use of an LMA form from negotiating in their own interests. Having said that, as the market has become familiar with LMA terms, the number of clauses that are negotiated in practice has diminished (a marker of the success of the standardisation project). The clause-by-clause commentary in the Guide highlights the clauses that are usually the subject of discussion and how they might be approached.

The key focus in documentation discussions is not, of course, on what is in the LMA templates, but on those topics that are not addressed (or not addressed completely) in the templates. These include, for example, the covenant exceptions required to make the LMA framework operationally workable for the relevant borrower, any commercial terms required to supplement those presented by the LMA (for example, any financial covenants) plus more topical developments that are not yet dealt with in the templates (for example, risk factors or impending regulatory changes that are still developing or whether there is a lack of consensus among lenders as to how they should be managed).

The LMA is proactive in providing guidance notes and updates on current issues affecting, or potentially affecting loan documentation to its membership, which largely comprises the lending community and their advisers. To anticipate lenders' demands, it is also important for borrowers to be on top of these issues and how they are being addressed in practice, including within LMA terms. The new edition of the Guide contains detailed commentary on the more recent changes to the LMA's templates and other talking points that borrower-side lawyers and treasurers may wish to think about before embarking on their next refinancing.

These are some of the issues we think borrowers should be aware of when negotiating facility documents (all of which are discussed in more detail in the Guide):

- Benchmark reform
- Negative benchmarks and IBOR floors
- Sanctions provisions
- The impact of IFRS 16
- Brexit and the loan market.

These topics are of relevance to the loan market generally and will be of interest to borrowers across the credit spectrum and their legal advisers. All (with the exception of Brexit) are relatively long-standing issues that the market has been working to digest for at least a couple of years; they remain current talking points because practice or the underlying regulatory regime is still developing.

Benchmark Reform

Many of the adjustments to the LMA's template facility agreements over the last two to three years have been prompted by changes (or anticipated changes) to the administration and calculation of LIBOR and EURIBOR, part of the ongoing global focus on ensuring the robustness and transparency of major benchmarks. From the borrower's point of view, the changes to the LMA's benchmark provisions are not particularly controversial, but they are numerous and need to be understood. In addition, they contain a number of options that may require discussion, such as the treatment of intra-day rate re-fixes and the fallback rates that are to apply if the Screen Rate for the relevant benchmark is unavailable:

- **Treatment of intra-day rate re-fixes:** ICE Benchmark Administration (IBA, the administrator of LIBOR) and the European Money Markets Institute (EMMI, the administrators of EURIBOR), each have error policies that provide for LIBOR and EURIBOR rates to be republished the same day if there is a problem in the calculation process. The relevant definitions in the Investment Grade Agreements provide the parties with the choice of whether or not to take into account any re-fixed rate. So far, no clear preference seems to have emerged. A factor in the appropriate choice may be the terms of any applicable interest rate hedging. The IBA and EMMI error policies provide a four hour window for rate re-fixing if required. Under standard ISDA terms, re-fixed rates will be taken into account only if they are published within an hour of the originally published rate.

- **Screen Rate fallback:** If the Screen Rate is unavailable, the customary fallback is a rate provided by an identified group of Reference Banks. The introduction of a regulatory regime for benchmark contributors (in the Financial Services Act 2012) prompted banks to focus carefully on both their responsibilities as benchmark contributors and (because quotes are typically required on the same basis) as Reference Banks. A number of banks have since indicated their unwillingness to act as Reference Banks in loan agreements. In many loan agreements the Reference Banks are no longer identified by name, instead left to be appointed as and when required.

Adjustments have been made to the LMA drafting to address this. The Reference Bank provisions were marked as optional in 2014 and a number of provisions were introduced to protect the Reference Banks from liability. In addition LMA terms now include an additional and optional Screen Rate fallback mechanic that provides for the use of interpolated and historic Screen Rates for a period before resorting to Reference Bank rates.

From the borrower's point of view, this optional alternative Screen Rate fallback provision is arguably preferable to reimbursing individual lenders' funding costs (the ultimate fallback rate, in the event Reference Bank Rates are not included, or unavailable when invoked). However, the longer fallback rate "waterfall", three years on has not been widely adopted. It is possible (in particular in the context of investment grade lending) that parties' views are coloured by its complexity and the perceived remoteness of the contingency catered for.

Negative Benchmarks and IBOR Floors

The impact of negative benchmarks on loan pricing has been a live issue in the European debt markets since Swiss franc LIBOR first dipped into negative territory in the summer of 2011. Under then-current LMA terms, "Interest" (the rate payable by the borrower to its lenders) was the sum of the agreed benchmark and the Margin. Accordingly, a negative benchmark rate would seem to have the effect of reducing the margin payable by the negative amount.

In response, "zero floor" language was gradually introduced into loan documentation and, eventually, into the LMA's forms of facility agreement. This language, which amends the definition of "LIBOR", "EURIBOR" and any other relevant benchmark rate, specifies that if the agreed benchmark rate falls below zero, it will be deemed to be zero for the purposes of the agreement.

Borrowers may take the view that the benchmark rate, which is supposed to be a measure of lenders' funding costs, should not be subject to a zero floor. Why should the lender not pass on the benefit of a negative interest rate to the borrower? Lenders will argue that they are unable to fund themselves at negative rates notwithstanding the negative benchmark; borrowers may point out that there is likely to be a mismatch between the benchmark and lender's funding rates whether the benchmark is positive or negative. Either way, the "pass-through" argument is simplistic and the omission of the zero floor language is often a point conceded by lenders for other reasons, in particular in the investment grade market.

This is likely to remain a topic for debate for so long as major benchmark rates remain below zero. At the time of writing, for example, this applies to certain rates for three of the five LIBOR currencies: Swiss francs, Japanese yen and the euro.

Sanctions Provisions

It has become very common for lenders to seek some level of contractual assurance from the borrower group, in the form of repeating representations or undertakings, or often both, with regard to sanctions. This practice developed in response to the increasingly aggressive enforcement action taken by regulators against financial institutions in respect of sanctions breaches. The penalties imposed by the authorities that certain institutions have suffered as a result of non-compliance with EU and US sanctions have been well documented. Sanctions provisions are not a feature of all investment grade loan agreements. In loan documentation generally, they now appear in some form more often than not.

When sanctions provisions first started to emerge, settling their terms absorbed a significant amount of time. That has faded somewhat as the core risks to be addressed, the borrower group's compliance with sanctions and the use of the proceeds of the facility in breach of sanctions, have become well understood. However, the scope and detail of the contractual terms still needs to be negotiated on a case-by-case basis. Different banks have different levels of sensitivity and there are a range of views on the appropriate scope of such provisions. In addition, some borrowers may conduct legitimate business (for example, under licence) in countries that are subject to sanctions, which the contractual provisions will need to take into account. As a result, although the LMA has produced a range of helpful guidance material, there are no recommended sanctions provisions in any of its English law forms of facility agreement. Borrowers are well-advised to consider this topic with their legal advisers at an early stage in the transaction, with a view to settling the key aspects of what is to be covered (if anything) at termsheet stage.

In addition to settling the scope of any representations and undertakings on this topic, more recently there has been increasing focus on the consequences of a breach of those provisions. In syndicated or clubbed deals, is an Event of Default the right result or should individual lenders instead be entitled to exit the deal? The potentially severe repercussions of being associated with a sanctions violation mean that some lenders are looking for individual rights to be prepaid and their commitments cancelled. For similar reasons, requests for changes to any sanctions provisions to be added to the list of amendments and waivers requiring unanimous lender consent are starting to crop up more often.

From the borrower's point of view, it is possible that a prepayment right could be preferable to an Event of Default, however whether the triggering of the prepayment right could avoid the cross-default implications of an Event of Default is heavily dependent on the drafting of the cross-default Events of Default across the borrower's financing documentation. The broader point for borrowers is to ensure that the sanctions provisions are manageable and reasonable and that appropriate policies and procedures are in place to avoid breaching them in the first place.

It has also become fairly common for lenders to propose similar representations and undertakings relating to anti-corruption laws, although the incidence of these is slightly less than in relation to sanctions. These typically cover the borrower group's compliance with the Bribery Act 2010, the US Foreign Corrupt Practices Act 1977 (as amended) and sometimes other relevant legislation. Although the scope of the risks presented by such legislation is slightly different, anti-corruption provisions often follow the broad shape of any sanctions provisions. This is discussed further in the Guide.

IFRS 16

IFRS 16, the long-anticipated new lease accounting standard, was published last year and must be implemented by companies using IFRS for accounting periods starting on or after 1 January 2019. IFRS 16 represents a major change to the current accounting treatment for leases. Under IFRS 16, subject to very limited exceptions, lessees will no longer divide leases into finance leases, which are currently accounted for on the balance sheet, and operating leases, which are not. The majority of lease liabilities must be accounted for on the balance sheet.

Most loan documentation follows the approach of the current accounting treatment and treats only finance lease liabilities as “Financial Indebtedness” or “Borrowings”. This is relevant for limited purposes in the Investment Grade Agreements, the defined term “Financial Indebtedness” being used only in the negative pledge and the cross-default Event of Default. However, in practice loan agreements often include other provisions, which bring these concepts into play. For example, if a covenant restricts the incurrence of “Financial Indebtedness”, which includes only finance lease liabilities, operating lease liabilities do not currently count towards that limit. Debt-focused financial covenants (for example the leverage, interest cover and cashflow cover covenants published by the LMA) often incorporate a definition of “Borrowings” (a slightly adjusted version of “Financial Indebtedness”) that typically includes only finance lease liabilities.

The question is how those references can be interpreted, and tested, once IFRS 16 is adopted. The long lead time for the new standard has meant that even in the years prior to the publication of IFRS 16, many borrowers had started to provide expressly in loan documentation that references to a “finance lease” should be interpreted in accordance with current accounting standards. Following the publication of IFRS 16, optional limitation language along these lines was incorporated into the LMA’s templates.

This is a helpful stop-gap. However, for agreements extending beyond 2019, it will mean that borrowers are likely to have to prepare two sets of numbers (one under the old accounting standard, one under the new) to illustrate compliance with relevant provisions of the agreement. In fact it is often the case that they are contractually obliged to do so for the purposes of financial covenant testing (the LMA agreements include an optional “floating GAAP” clause for this purpose).

The stop-gap language also does not assist with the question of how lease liabilities will be incorporated into debt limits, financial covenant tests and other relevant provisions in loan agreements entered into on or after the new standard is adopted. It might be anticipated that loan documentation will continue to follow the accounting treatment, in which case the limits of any affected provisions will need to be re-set to incorporate the group’s newly adjusted lease liabilities. For some types of business, on paper at least, this seems likely to involve a significant increase in leverage.

Other clauses or definitions customarily used in loan documentation may also require adjustment once the new standard is implemented. Moving operating lease assets onto the balance sheet results in an increase in the company’s or group’s gross assets. This may affect contractual mechanisms such as guarantor coverage tests that impose a threshold by reference to gross assets. There will also be interest expenses and charges to depreciation in respect of “old” operating lease assets, which may impact defined concepts of EBITDA.

As we move towards 2019, borrowers will need to be ready to discuss with their lenders the impact of IFRS 16 on their business, with a view to making appropriate changes to their loan documentation. This is very similar to the covenant re-set exercise that many had to undertake when adopting IFRS for the first time back in 2005. In anticipation of IFRS, a number of loan agreements incorporated a clause endorsed by the ACT and the LMA, which provided a framework for the parties to co-operate to adjust affected terms, without altering their commercial effect. This clause (the text of which is set out in the Guide), may prove useful to some in easing the transition to IFRS 16.

Brexit and the Loan Market

The prospect of Brexit and its potential impact on the loan market is the risk factor that has received the most attention from loan market participants over the last 12 months. Most banking lawyers have reviewed the potential documentation implications of Brexit in some detail.

Areas of focus have included:

- Whether the provisions that enable lenders to change the facility office through which their participation is provided or to transfer the loan to another entity within their group are sufficiently flexible to accommodate post Brexit restructuring.
- Whether English law continues to be an appropriate choice of law for lending transactions.
- The impact of Brexit on dispute resolution options and the popularity of submissions to the jurisdiction of the English courts (current market practice being underpinned by EU legislation).
- The use of references to the EU and to EU legislation in lending documentation.
- The tax implications of leaving the EU for payments under loan documentation.
- Whether a bail-in clause should be included in English law loan documentation in the same way as required by Article 55 of the EU Bank Recovery and Resolution Directive in loan documentation governed by the law of a non-EEA country.
- Whether Brexit, of itself, could trigger an Event of Default or prepayment event under LMA terms.
- Whether lending documentation should include clauses that contemplate adjustments to particular terms after the UK leaves the EU, or specific termination rights.

Although these topics (and others) have been analysed in some detail, in general none have prompted changes to documentation terms that are being adopted on a market-wide basis. The only exception is that in any new documentation, if a clause incorporates a reference to the EU, the parties may specify whether that term is intended to include the UK.

In relation to a number of the points initially identified, this inaction is because closer analysis has led to the conclusion that Brexit is unlikely to present an issue, at least from a UK perspective. For example, the application of the UK withholding tax regime as it affects payments under a loan agreement is not predicated on EU membership, nor is the validity of a choice of English law under the Rome I and Rome II regime.

In other cases, there is consensus as to the nature of the risk, but whether the risk needs to be addressed contractually depends on the outcome of the UK’s exit negotiations. For example, post Brexit the UK will no longer benefit from the Brussels Regulation that ensures exclusive jurisdiction clauses will be respected by EU member state courts. However, there is thought to be considerable incentive for the remaining EU member states to agree some form of reciprocal arrangement as part of the UK’s exit negotiations to ensure that their own judgments remain enforceable in the UK (as well as a number of legal options that the UK may take itself). The general conclusion so far has been that the likelihood of this risk materialising is not sufficiently high as to outweigh the benefits of current market practice. The question of whether to include a bail-in clause in English law loan documentation also falls into this category.

A conclusion on many of the points listed above is awaiting further information on the detail of the UK’s exit and any transitional arrangements. This is reflected in the LMA’s response. Although it has published some helpful guidance material and some slot-in “Designated Entity” language (see below), it has not yet recommended any changes to its template documentation. As a result, the need for and extent of any Brexit related adjustments is likely to require attention in most loan transactions for some time to come (even if the conclusion, as in most cases currently, continues to be that no action is required).

Loss of Passporting Rights and "Designated Entities"

The key concern for lenders in relation to loans and other products is of course whether they will be able to continue to offer those products post-Brexit if the EU passports on which they are currently reliant are withdrawn. Commercial lending is not a regulated activity in the UK; however that is not the case in all EU countries so there will be transactions where a lender currently holds its commitment and/or participation through its UK entity and lends to borrowers in relevant EU countries in reliance on its passporting rights under the EU Capital Requirements regime. If those rights come to an end (and local regulation in the relevant country requires the lender to be locally authorised to continue to participate in the relevant facility), the lender may need to transfer its commitments to an appropriately authorised local entity or exit the deal.

Current LMA terms provide lenders with a certain amount of flexibility in this regard: transfers and assignments to Affiliates do not require borrower consent and lenders are entitled to be prepaid and their commitments cancelled if it becomes unlawful for them to continue to participate in the facility. Prompted by these concerns, the LMA recently published an additional "slot-in" mechanic that permits lenders to designate locally authorised Affiliates to participate in particular loans under a syndicated facility. This "Designated Entity" language enables lenders to have appropriately authorised local affiliates ready to step in to take on particular loans, without the need (subject to applicable regulatory requirements) to pre-allocate capital in the relevant countries or undertake a full transfer process.

A Note on Exchange Rates

Although most loan documentation has so far been unaffected by the direct implications of Brexit, some borrowers have had to consider the implications of the effect the EU referendum result has had on the value of sterling. Exchange rate movements affect different companies in different ways but for some companies, currency movements can affect their capacity to operate within their lending terms. Examples of provisions that might be affected include the following:

- **Multi-currency facility limits:** Under LMA terms, the facility limit for a multi-currency facility is set in a Base Currency. Drawings in other currencies are converted into the Base Currency at a spot rate at the time of drawing. Borrowers with multi-currency facilities where sterling is the Base Currency will have found themselves needing more headroom to draw in US dollars over the last twelve months.

- **Financial covenants:** The simple point is that exchange rate movements that affect a group's financial performance may therefore have an effect on its financial covenant tests. The more complicated point is whether discrepancies in the exchange rates that are applied to different components of a financial covenant test might affect the outcome of those tests. This is not a new point; some European companies subject to leverage covenants breached their covenants as a result of currency movements against the US dollar in the immediate aftermath of the 2007 financial crisis. A leverage covenant compares a balance sheet number at a particular date (such as Total Net Debt) against an income statement number over a period (EBITDA). Accordingly, foreign currency amounts will be taken into account at differing rates for the purposes the Total Net Debt and the EBITDA sides of the ratio, which can cause problems if relevant currencies have moved significantly over the course of the testing period.

- **Basket capacity:** Exceptions to certain negative covenants (such as restrictions on disposals and on the incurrence of debt) in the corporate lending market often include a “basket” amount subject to a monetary cap (in other words, the restricted action can be taken in an amount up the value of the cap). The cap is typically set in the currency of the facility. If restricted actions in reliance on the basket are incurred in other currencies, a conversion will need to take place. Unforeseen or extreme currency movements may therefore have the potential to affect anticipated basket capacity.

The above are some of the main examples of areas of a loan agreement that might be affected by currency movements. There are other more detailed points and the picture may be complicated by hedging arrangements and other variables. The issues that might arise are therefore very company specific. Issues related to exchange rates have been raised on a number of more recent transactions, which in some cases have prompted bespoke contractual adjustments.

Further Information
All of the points covered in this article are discussed in more detail in the Guide. The Guide is available for download from the ACT’s website or from the publications and seminars section of Slaughter and May’s website. In-house lawyers and treasurers may obtain hard copies of the Guide by contacting actguide@slaughterandmay.com.

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