# Hot source

DESPITE THE VOLATILITY, THE DELEVERAGING AND THE RETREAT TO CORE GEOGRAPHIES, BANKS REMAIN UK CORPORATES' LOAN PROVIDERS PAR EXCELLENCE. **IAN FITZGERALD** CONSIDERS THE CHANGES IN THE LOANS MARKET AND OFFERS BORROWERS SOME GUIDELINES.

Borrowers will face interesting challenges in raising loans for refinancing, M&A or capital expenditure, due to the continued structural reduction in available liquidity across the market. The combination of more onerous bank capital requirements, a challenging funding environment for lenders and weak economic growth means that for borrowers, especially mid-market corporates and smaller companies, this is not an issue that will go away any time soon. This article looks at the market conditions and issues facing banks, and offers fundraising guidelines.

The bank loan market has been one of the most significant and efficient sources of core funding available to corporates. With typically only the larger corporates significantly diversifying their funding through active use of bonds and other capital market products, many borrowers remain heavily reliant on banks for financing and are likely to remain so for the foreseeable future.

While a number of alternative financing sources are developing for middle market and more domestically focused borrowers, many of these initiatives are at a relatively early stage of development and are likely to take some considerable time to evolve fully. In this context, many borrowers currently have few alternatives to bank loans.

Yet the syndicated loan market has become a more volatile and less reliable source of financing. There has been a permanent reduction in the number of bank lenders, with many of those left having less capital and liquidity available to support pure lending activities.

For the international capital markets, the last five years have been turbulent indeed. But while loans are now more expensive than before the crisis when liquidity abounded, they are often still cheap compared to alternative non-relationship financing.

Bank lenders have become far more focused on the non-client drivers of the business. These include their own capital and funding challenges and the immediate benefits here from reducing lending and secondary loan sales. Many have retreated from non-core markets to ones where they have competitive advantage – typically their domestic market and core customers. At the same time, bank shareholders are developing a rarely seen feistiness.

Those borrowers that have been coming to the market against the backdrop of the euro zone crisis have in many cases been fortunate in that what they have sought has been achievable even though lending volumes have collapsed to levels last seen nearly two decades ago. Many larger borrowers were able to take advantage of the window of opportunity that opened between mid-2010 and mid-2011 to address near-term future maturities. They did so through a combination of capital market issuance that refinanced core drawn debt at historically low spreads and replaced undrawn revolving credit facilities, typically with a reduced quantum asked of the syndicate.

Most loans undertaken throughout the euro zone crisis have been refinancing-driven, with individual transactions relatively modest in size and therefore easily accommodated by core relationship banks. New money demand has been negligible given the uncertain economic environment and the general dearth of M&A activity. This has masked the lack of genuine depth to the market.

The potential liquidity crisis surrounding the lender community was effectively addressed at least in the near term by the European Central Bank flushing €1 trillion of three-year term funding through the market via the two LTRO (long-term refinancing operation) prints.

While short-term issues can be, and in many cases are being, addressed, many of the challenges facing the market are long-term or structural in nature. More than ever before it will be essential that borrowers understand the implications of the market's major drivers, lender behaviour and the challenges facing banks' loan businesses.

A large number of the major issues facing the market will not simply go away. Available permanent bank loan liquidity will therefore remain a more limited, scarcer and less reliable resource than in the past.

Many FDs and senior treasurers will already have a well-developed perspective on the markets and the best ways of handling banks. However, in an environment where rapid change is the norm and the key drivers of lender liquidity and behaviour are a long way removed from the "relationship coalface", the banker perspective is arguably more relevant than at most times in the past.

In the future, a deeper understanding of the events and implications of regulatory change and other key drivers of lender behaviour will be essential. Just as important will be the ability to interpret this information correctly from an individual borrower's perspective and apply it to a specific situation.

In this context, it is worth highlighting some of the key drivers that will be framing the borrowing environment for the foreseeable future and the likely impact on the loan market.

Regulation is front and centre, with the banking community facing a plethora of new and changed rules. Some will have intended, while others will have unintended, consequences for the industry. Among the key initiatives on the regulatory landscape is BIS/Basel III's matrix approach to bank regulation, with its combined focus on capital, leverage and liquidity. The European Banking Authority has also set a core tier one capital target of 9%.

Other initiatives that will have a less direct but still major influence on bank lending are FATCA (the US tax compliance law involving foreign financial assets and offshore accounts), the US Dodd-Frank Act (intended to prevent another financial crisis), and Solvency II (the new EU framework for insurance regulation).

Each of these initiatives is already having or will have an impact on the bank loan market. For example, Basel III has put capital at the forefront of most banks' agendas. A new Fitch Ratings study says that to meet Basel III standards the world's 29 largest global banks will need to raise an extra $566bn in new capital or shed about $5.5 trn in assets by 2018. Capital creation and preservation will be a priority for the foreseeable future.

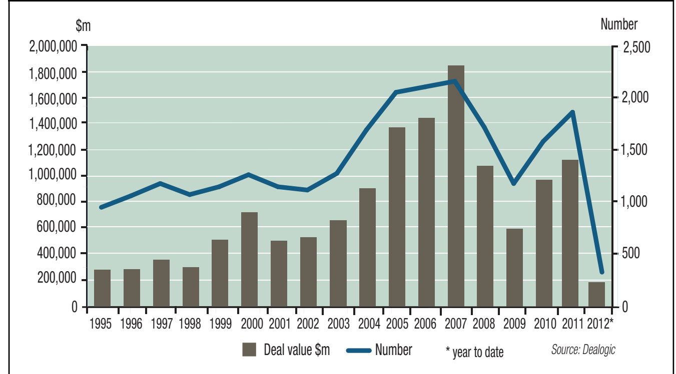
Already this is evidenced by reduced lending activity. The affected banks are being forced to make portfolio reductions, and secondary loan sales are competing for appetite with primary. The result is a de-emphasis of the lending product at some institutions and generally higher pricing. Balance sheet shrinkage in the financial sector continues, with $2.6 trillion of synchronised deleveraging forecast.

In an environment where there are now more structural challenges facing the lending business than in the past five years, borrowers would be well advised to continue to manage their relationships actively and maintain a continuous dialogue.

The number and strength of bank relationships remain a key determinant of success. As the number of banks involved in the corporate market has declined, transactions have shifted from widely syndicated loans to club or quasi-club facilities orchestrated by the borrower, with generic advice provided by a core of house banks or a close trusted adviser. Self-arranging is common across all major jurisdictions including the emerging markets where relationships are less mature.

Senior treasurers from larger companies with multiple bank contact points will have a good understanding of all these issues. But for smaller companies with less available resource, and less natural interaction with banks, knowledge is clearly one of the key ingredients. The more of the KYs or "know yours" that are understood, the better. The key KYs are know your bank (drivers,

**EMEA syndicated loans:** volume 1995–2012




capacity, decision-makers, processes and market experts), know your value (to each lender), know your alternatives, know your market, and know your competition.

Knowledge and understanding of best practice is essential when executing in challenging markets. In the context of a specific transaction, making informed judgments around the most appropriate timing to market is critical.

This was demonstrated by a number of borrowers in 2011. Those going to market early were able to take advantage of the then open window of opportunity to get deals successfully completed on favourable terms. Those that delayed until after the summer got caught up in the euro zone crisis and general liquidity retreat.

Timing may also raise structural issues for consideration, particularly in the case of maturities. For while it clearly makes sense to lock in funding for as long as possible, consideration should also be given to the scale and timing of the future refinancing cliff being created. Indeed, in certain circumstances a staged maturity structure may help address potential concerns on maturity concentration and also facilitate the provision of bank liquidity.

Similarly, the positioning of banks in a syndicate and the assignment of appropriate titles, positions and roles within the structure of the syndicates or clubs need to be well understood and managed. The aim is to ensure that capital availability and lending commitment from all key lending banks is maximised and that no banks are alienated.

Looking forward, market volatility seems almost inevitable over the coming months and possibly years. The recent election outcomes in France and Greece deliver a direct challenge to the existing approach to the euro zone crisis as European electorates reject austerity measures and their implications.

Despite all the uncertainty and challenging markets it is worth noting that well-structured and correctly priced loans have, almost regardless of market conditions, always been successfully concluded. The loans market will continue to provide the right finance at the right time, for the right reasons, and remain the cornerstone of corporates' future funding strategies.

Ian Fitzgerald is chief executive of Loans & Syndications Advisory Services.
**ian.fitzgerald@loanssas.com**
www.loanssas.com