SHIFTING SANDS

REGULATION AND THE ECONOMIC CLIMATE HAVE HAD AN IMPACT ON LOAN TERMS. KATHRINE MELONI AND STEPHEN POWELL HIGHLIGHT SOME ISSUES FOR TREASURERS PRIOR TO THEIR NEXT LOAN REFINANCING

The period since the collapse of Lehman Brothers in 2008 has been a challenging one for the debt markets generally and the syndicated loan market in particular.

Legal and regulatory initiatives and the ongoing de-levering of the banking sector have progressed against the backdrop of recession and a weak economic outlook, conditions that have been exacerbated across Europe as the problems in the eurozone became public and eventually erupted.

The authorities' response to the 2007-2009 financial crisis included a significant – probably unprecedented – volume of new financial regulation, most with the potential to impact corporate loan products, directly or indirectly. In part due to the unpopularity of certain measures among affected parties, the process of regulatory change has been a protracted one, especially the finalisation and implementation of the various elements of Basel III, which now seems unlikely to come into force in the EU before 2014.

On top of crisis-driven regulatory changes and suboptimal market conditions, participants in the loan market have had to grapple with a number of other issues, such as Libor manipulation and the prospect of benchmark reform, the impact of certain foreign legislation, such as the Foreign Account Tax Compliance Act (FATCA), as well as the prospect of some material changes to accounting standards.

The effect of these developments on loan documentation is twofold. First, any resulting costs must be quantified and either built into the pricing of the loan or allocated contractually within the various indemnity provisions that are now a customary feature of corporate lending terms. Secondly, where necessary, measures need to be put in place to facilitate compliance with, or to address the impact of, any new and applicable legislative and regulatory provisions, accounting standards or risk factors.

Lenders, treasurers and their advisers spent much of 2012 trying to assess and determine how to manage these challenges, a process that is still ongoing. The result is that as we enter the second quarter of 2013, there remain a number of issues with the potential to impact loan transactions, the implications of which are not fully or specifically reflected in template documentation, including the Loan Market Association (LMA) recommended forms of facility agreement. These issues therefore require consideration and negotiation on a case-by-case basis. It is important that treasurers are aware of them and anticipate the likely position their lenders might take.

The key issues that are commonly the subject of discussion in current transactions include:

Financial sector regulation: The extent to which the risk of increased cost claims arising out of the various significant financial regulatory changes on the short-term horizon should be borne by the borrower remains contentious. Such measures include the EU and domestic legislation required to implement Basel III pending finalisation. The treatment of derivatives exposures in loan documentation also warrants focus. Whether borrowers are permitted to collateralise derivatives exposures under current lending terms may need to be addressed with increasing frequency in light of the European Market Infrastructure Regulation and other regulatory developments affecting the derivatives industry.

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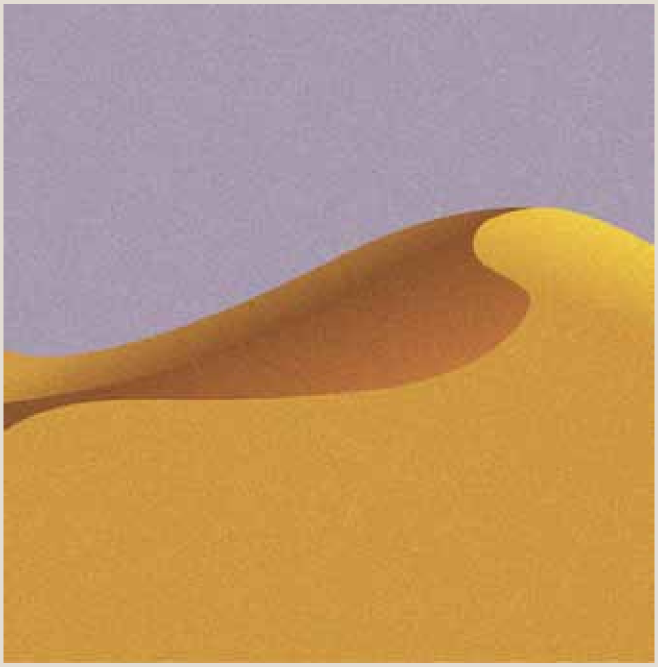
The aftermath of the Libor scandal: This is of critical importance to the loan market, BBA Libor having been devised to meet the needs of lending syndicates. The recommendations contained in the Wheatley review of Libor, published last September, have been progressed with impressive speed, raising the prospect of a new administrative framework for Libor, and potentially an altered benchmark by the end of 2013. There are still some questions about whether the process of benchmark reform has the potential to disrupt existing lending arrangements that reference Libor (and the Euro Interbank Offered Rate), a subject on which the ACT continues to engage with the LMA.

The impact of foreign legislation, including FATCA: US lawmakers have produced a number of new legislative provisions with extraterritorial effect, including, perhaps most notably, FATCA. FATCA requires foreign financial institutions to provide detailed information to the Internal Revenue Service



regarding their US account holders or face a punitive withholding tax on, *inter alia*, their US source income. The emergence of intergovernmental agreements (IGAs) over the past few months should mean that the impact of FATCA is not as significant as initially feared (and, importantly, enable lenders in IGA jurisdictions to accept the tax risk), but FATCA requires discussion in most current deals.

Changes to the lease accounting regime: There are major accounting changes afoot with the potential to affect loan terms, including the US Financial Accounting Standards Board's and the International Accounting Standards Board's proposal to dispense with the distinction between finance and operating leases. Finance lease liabilities are typically included in covenant restrictions on indebtedness and security in lending documentation as well as for the purposes of debt-based financial covenant calculations. Some borrowers, in particular those with significant operating lease commitments, may wish to pre-empt the potential difficulties in interpreting such references should the accounting changes come into effect during the term of the loan.

The impact of market conditions: Provisions aimed at protecting the borrower and the finance parties in the event of lender default, insolvency and market disruption have become a familiar theme. The possibility of eurozone fragmentation and the effect that a change in euro membership might have on loans or payments denominated in euros has been added to that agenda over the past 18 months, prompting in many cases, some minor changes to facilities denominated in euros.

The position of the agent and other administrative parties: In a loan market dominated by refinancing and 'amend and extend' transactions, where consents and waiver requests may occur with more frequency, agent banks are re-examining the risks involved in agency and other administrative roles and the allocation of any related costs incurred in the performance of such functions. There are a number of good reasons why investment-grade borrowers in particular should be able to resist suggestions that they should take on any more extensive liability to the agent than has been customary.

Mandatory costs: Agent banks have expressed concern about the operational difficulties they experience in the administration of the LMA's 'mandatory costs' formula, the mechanic that entitles lenders to pass on their supervisory costs to borrowers. These concerns led the LMA in March to withdraw its mandatory costs formula and highlight in a note to members some possible alternative approaches to mandatory costs that borrowers will need to evaluate as proposed. The basis on which lenders will recoup mandatory costs going forward (if at all) in the absence of an LMA formula remains to be seen. This issue has only come to light recently and alternative proposals have not yet filtered into documentation discussions.

For the time being, treasurers should not generally consider provisions relating to the above matters proposed by lenders as representing market practice. Treasurers will need to discuss with their advisers the appropriate approach and what they might be able to achieve in the context of the loan in question.

The ACT has worked with the LMA on its recommended forms of syndicated facility agreement for investment-grade borrowers (the *Investment Grade Agreement*) (and its revisions) since the project was first launched in 1996.

Last month, the ACT published a new edition of its *Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers*. The guide is intended as a reference tool for treasurers and provides a clause-by-clause commentary on the provisions of the *Investment Grade Agreement*.

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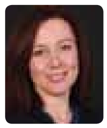
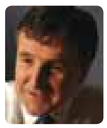
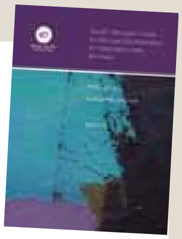
The new edition of the guide has been updated to address the various changes that have been made to the *Investment Grade Agreement* since the last edition in 2010. Much of the new content is aimed at equipping treasurers to anticipate the new areas they might be required to navigate when they next come to refinance. The sheer number of current issues was a key driver for the timing of the new edition. Treasurers are referred to the guide for further information on each of the issues highlighted above, together with an outline of some of the ways in which they have been managed to date.

The guide was created to assist treasurers. Readers' comments, observations and suggestions for future content are welcome.







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