# Plenty of capacity in the loan markets

With support for ambitious corporate projects involving massive amounts, the market for loans is growing at an unprecedented rate, says Clare Dawson of the LMA.

After 1999 set new records in the European loan market, with activity continuing right up to year end, this year started a little more slowly than many had anticipated. Nonetheless, now we are well into the second half, 2000 looks set to be another strong year for the market. M&A activity is still strong, and after a slow start the leveraged loan market has begun to show encouraging signs of development.

As in 1999, corporate restructuring in continental Europe has been a strong driving force in both the investment and non-investment grade markets. The France Telecom and KPN deals were particularly noteworthy both for their size and successful reception. This shift from a UK-dominated market to a genuinely pan-European one, both in jumbo and medium-sized deals, has brought more institutions into the market. However, for UK borrowers there may be a risk that the growth of activity on the continent could divert the attention of investors away from the UK.

**Positive signals continue**

Nonetheless, the loan market continues to send out positive signals. It has clearly demonstrated its capacity to support very ambitious corporate acquisition plans, involving amounts that would previously have been regarded as at the limit of capacity. Successful take-out of bridge financing by the capital markets has given banks the confidence to go into deals with big-ticket commitments, and bank consolidations have increased the capacity for large underwritings. In this context, the continuing growth and liquidity in the secondary market has also been a major factor in adding to primary market capacity. Data collected by the Loan Market Association (LMA) from our members indicates a continuing upward trend both in the volumes of secondary activity, and in the number of banks involved (*see Figure 1*).

> The loan market continues to send out positive signals. It has clearly demonstrated its ability to support very ambitious corporate acquisition plans, involving amounts that would previously have been regarded as at the limit of capacity

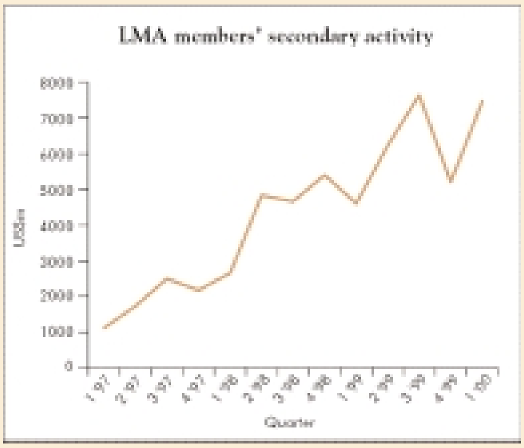
On the leveraged side, a number of factors have been driving the market this year. The first half saw a number of refinancings as well as a steady flow of small to medium-sized buyouts. Structured telecom deals have also formed a significant part of the leveraged market, and more recently we have seen larger sponsor-driven deals start to appear. As leveraged lending skills have become more widely distributed around the market, capacity to absorb larger deals has improved, but the European market clearly still has a long way to go before it has the depth of the market in the US. Particularly with regard to the role of the non-bank investor in the European leveraged market, we are perhaps still in a chicken-and-egg situation. Until deals are structured in such a way as to be attractive to non-banks, it will not be worth their investment in skills and resources to participate in the loan market. However, without an alternative pool of investors, arrangers will continue to structure deals around banks' requirements. Arguably a significant non-bank investor market will only develop in Europe when the need for liquidity outstrips the supply from banks.

Clare Dawson

**Concentration concerns**

As corporate activity in the telecoms sector continues to generate a requirement for significant amounts of credit, there are perhaps the first indications of concern about industry concentrations on bank balance sheets. This, together with the continuing trend for bank consolidations, is further focusing attention on the need for loan portfolio management. In this climate, secondary market liquidity is essential to enable banks to have the confidence to continue to take on the size of commitments that is required in the larger deals. These commitments are likely in many cases to significantly exceed the banks' appetite for the asset as a long-term hold position. Banks' willingness to sign up to the deals in primary syndication at these levels is therefore likely to be governed largely by their confidence in reducing their final take in the secondary market.

*FIGURE 1*




### *Transferability debate continues*

Looking at the secondary market, the debate between borrowers and lenders over transferability still continues. On the face of it, in the primary markets banks may seem largely to be winning the argument that allowing them to transfer debt has advantages for borrowers as well as banks. No doubt the fact that many borrowers are still looking to raise amounts far beyond their previous experience, and beyond the capacity of their usual relationship banks, has had a part to play in this development. However, an area of concern for the LMA is that we still hear from secondary traders that some borrowers continue to act against the letter, as well as the spirit, of agreed transferability wording. Clearly this can work to no-one's advantage if, as a result, banks have less confidence in their ability to manage their loan book in a prudent and responsible way.

### *Creating additional liquidity*

For the LMA, the strength and pace of the loan market's development has been reflected in our own level of activity. Taking as our fundamental goal the creation of additional liquidity in both the primary and secondary markets – and indeed we would argue that the two are inextricably linked – we have undertaken a number of initiatives that directly address this issue. We also continue to work to spread awareness of issues relevant to the loan market, not least by our ongoing programme of roadshows, which saw us in Milan in March, and which will continue with a visit to Bahrain in the autumn.

The leveraged loan market in Europe remains relatively underdeveloped, and in particular the role played by non-bank investors in this market is very small compared to the US, where around 40% of funds are provided by non-banks. While many of the issues which inhibit further participation in this market are structural, there are a number of regulatory issues which have a more fundamental effect in restricting non-bank investors' participation in the loan market. In considering how the LMA might help in this regard, as a starting point we concluded that the best issue to focus our efforts on was the rules on UK withholding tax, which currently place non-bank investors at a disadvantage compared to banks. We shall be lobbying to extend the exemption on interest payments for banks and similar authorised European institutions to include appropriate categories of non-bank financial institution, thereby increasing the pool of potential investors that can participate directly in syndicated loans to UK companies.

### *Continuing dialogue with regulators*

As the LMA consolidates its position as the voice of the syndicated loan market, dialogue with regulators is becoming an increasingly important part of our activities. Our emphasis is always to try to maintain the flexibility that is one of the major advantages of the loan product, and to increase liquidity by allowing access to the widest possible range of appropriate investors. Particularly in the UK, where the loan remains outside the regulatory regime for investment products, much of the work we have undertaken has been to point out anomalies that have arisen as a result of legislation directed at other products, but having a consequential effect on the loan market. An example of this, on which the ACT also lobbied, was the situation that arose *vis-à-vis* loans with ratcheting margins. We were pleased to see that this obvious anomaly, whereby the interest to non-UK lenders on loans to UK corporates, on which the margin fluctuated in line with business performance was taxed as a dividend rather than interest, was modified in this year's Finance Bill. Closer reading of the draft legislation revealed that the tax treatment had in fact only been changed where the ratchet related to borrower, as opposed to group, performance, and we subsequently urged the Treasury to make the additional change to reflect the fact that many loans are structured around group entities rather than single borrowers. In the absence of any change in the Finance Act, we are continuing to press the Inland Revenue for clarification on this.

The LMA's biggest project in 1999 was the production of the Recommended Form of Primary Documents, a number of additions to which are currently being produced, such as swingline or acceptances options. The involvement of the ACT in this project was undoubtedly of great value in helping to gain market acceptance for the documents, and we are keen to build on this co-operation to create an ongoing dialogue with the borrower community. There can be no doubt that lenders and borrowers can initially appear in some cases to have different interests. Nevertheless, the continuing success of the syndicated loan as a means for supporting corporates' acquisition programmes, as well as their regular financing requirements, is indicative of the flexibility of the loan product and the attraction a correctly structured and priced deal has for both groups. ■

> Secondary market liquidity is essential to enable banks to have the confidence to continue to take on the size of commitments that is required in the larger deals

*Clare Dawson is the Loan Market Association Executive.*

*The LMA is sponsoring an ACT evening discussion on loan portfolio management and its impact on banks' relationships with borrowers, to be held on 27 September. Further details are available from Kate Frere at the Association (kfrere@treasurers.co.uk).*

*The ACT guide to the LMA Agreements can be found on the Association's website www.treasurers.org.*