The Association of Corporate Treasurers

Syndicated loan facilities:

non-bank Lenders, and the influence of credit derivatives: current issues and opportunities for Borrowers

Part 2

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

Produced with assistance and sponsorship from
SLAUGHTER AND MAY

London, July 2007

TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

This document may be freely quoted with acknowledgement

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including *The Treasurer* magazine.

Our 3,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit **www.treasurers.org**.

Guidelines about our approach to policy and technical matters are available at **www.treasurers.org/technical/resources/manifestoMay2007.pdf**.

This briefing note was drafted by Slaughter and May for the ACT's Policy and Technical Department (e-mail: **technical@treasurers.org**) and commented on by members of the Policy and Technical Committee and others to all of whom thanks are due.

NOTE
Although the ACT and Slaughter and May have taken all reasonable care in the preparation of this guide, no responsibility is accepted by the ACT or Slaughter and May for any loss, however caused, occasioned to any person by reliance on it.

ACT
51 Moorgate
London EC2R 6BH, UK
Telephone: +44 (0)20 7847 2540
Fax: +44 (0)20 7374 8744
Website: **www.treasurers.org**

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address

Part 2

The influence of credit derivatives on syndicated lending

Part 1 of this note focussed on the debate about non-bank Lenders, and the techniques available to Borrowers wishing to control and manage their syndicate membership.

This Part 2 focuses on the influence of credit derivatives on syndicated loans.

The value of the global credit derivatives market has increased massively over the last few years, to $26,000 bn in July 2006, according to ISDA. This development is one of the factors which has created the currently friendly climate for Borrowers in the UK. Along with low interest rates, the growth in the appetite of CLOs and hedge funds, and the development of the secondary loan markets, the hedging and arbitrage capabilities of credit derivatives have fuelled an increasingly Borrower-friendly market, especially in the leveraged sector. There has been extensive press coverage of the ease with which it is currently possible to raise substantial amounts of syndicated debt with tight pricing and loose covenants.

Credit derivatives are a major tool in Lenders' credit risk management strategy. They also provide significant regulatory capital benefits for banks. Although the attractiveness of credit derivatives may have originated in Europe in their hedging capabilities, the arbitrage opportunities are now so great that some credit derivative sellers are effectively originating loans to investment-grade Borrowers. Such is the appetite for the derivative that its terms may be settled at the same time as the underlying loan.

The most popular type of credit derivative is the credit default swap. Although to date credit default swaps ("CDS") have been written mostly on well-known corporates, trading in CDS on less well-known names is burgeoning. Likewise, the market for CDS relating only to leveraged loans ("LCDS"), though in the early stages of development in Europe, is growing fast.

From a Lender's point of view, one of the most attractive features of a credit derivative in relation to a loan is that it usually enables the Lender to transfer credit risk without regard to the transfer restrictions in the loan agreement, and without reference to the Borrower. Lenders are not usually under any legal obligation to provide Borrowers with any information about their credit derivative cover, and typically take the view that it is commercially in their best interests not to. As a matter of law, these transactions do not generally give the counterparties direct rights against the Borrowers, so, the argument goes, they need not be a concern to them.

While there could be potential benefits for Borrowers in terms of the liquidity and pricing opportunities deriving from the credit derivatives market, there are also problems to be addressed. Where the Borrower is untroubled by financial difficulties, these problems may not materialise. At the point at which the Borrower needs a waiver or an amendment to its facility, or faces insolvency, however, they may become critical. There is a risk that a Lender's voting behaviour may be influenced, or even in some cases determined, by an unknown third party. In some cases, ultimately, the third party may also acquire the Lender's loan participation.

The rest of this note analyses the salient features of credit default swaps for syndicated loans, and sets out some potential issues for Borrowers and strategies for addressing them.

Credit default swaps: impact on syndicated debt

The defining function of a CDS is the provision of protection against credit risk, as distinct from the other risks taken by a Lender. The key feature of a CDS is thus the definition of a Credit Event, the occurrence of which triggers the settlement mechanism (see box below).

The ISDA Credit Events and LMA Events of Default

Most CDS are documented using ISDA standard terms. Where ISDA terms are used, the parties select which Credit Events are applicable. In Europe, these are usually Failure to Pay, Bankruptcy and Restructuring.

The ISDA Credit Events are not identical to the equivalent Loan Market Association Events of Default. Generally speaking, the ISDA Failure to Pay and Bankruptcy Credit Events may occur later than the equivalent LMA Events of Default, while the ISDA Restructuring Credit Event could be triggered before an LMA Event of Default.

The ISDA Failure to Pay Credit Event is triggered by reference to defined obligations (commonly Borrowed Moneys Indebtedness) after the expiration of any applicable grace period, and is usually subject to a threshold amount.

The ISDA Bankruptcy Credit Event is similar to the LMA insolvency-related Events of Default but in general may occur later.

The ISDA Restructuring Credit Event is widely regarded as problematic. In outline, it requires a reduction in an interest rate or the amount of principal repayable, a postponement of payment dates or a change in priority to be agreed or announced in a way which binds all the holders of the debt. However, the meaning is uncertain, and in the case of Marconi for example it caused major difficulties. However its inclusion makes it attractive to Lenders, especially as it permits full regulatory capital relief under Basel II.

In a CDS, the reference obligations may include, for example, the reference entity's bonds and bank debt; an LCDS references the leveraged syndicated debt only. In "single-name" CDS, the Borrower and other group members will constitute the reference entities. (This note does not discuss "portfolio" CDS).

The Lender, as protection buyer (the "Buyer"), pays the protection seller (the "Seller") a fee fixed by reference to the notional amount of the transaction for a fixed period.

Trading

A Lender may sell its CDS; and CDS referencing a Borrower's syndicated debt and bonds may be traded by institutions other than its Lenders and bondholders. When the Borrower needs, for example, to request a waiver for a breach of covenant under its loan agreement, its primary focus may be on the CDS cover referencing that debt which is held by its Lenders, as the parties with whom it has a direct relationship (this scenario is explored further below). It will however also need to bear in mind the interests of holders of CDS referencing its debt which are not also Lenders and bondholders. Indirect pressure from the CDS market may be substantial, but need not always be disadvantageous. The fee paid to Avis to provide a guarantee for its bonds, reported in the Treasurer of March 2007, is a good illustration.

Credit Event

On the occurrence of a Credit Event, it is usually agreed that either party may call for settlement on production of supporting evidence in the form of publicly available information from sources such as Reuters or the FT. Settlement may be physical or in cash.

Settlement

Physical settlement involves the delivery of securities or loans satisfying specified criteria with a par value equal to the notional amount of the CDS, in exchange for a cash payment by the Seller of the notional amount (the par value). The Seller thus compensates the Buyer for the loss in market value of the reference obligation following the Credit Event.

The securities which may be delivered may include for example "consent required loans" and "assignable loans" as well as listed bonds. As a result, when a Credit Event occurs, and the Borrower's syndicated debt qualifies as a deliverable obligation, physical settlement may involve a transfer of that debt to the Seller, subject in applicable cases to its consent. The Buyer may however elect to deliver other deliverable obligations, and thus remain as Lender.

Although physical settlement is the most common method, it is not always possible, as the notional amounts of CDS in the market are liable to exceed the amount of the underlying debt. In European LCDS, the Seller can elect for cash settlement where, for example, the Buyer proposes to sub-participate because required consents are not obtained.

On cash settlement, the Seller pays the difference between the notional amount of the CDS and the current market value of the reference obligation selected by the Buyer. The Buyer thus remains the Lender in relation to the syndicated debt.

Invisibility

As with other credit derivatives, there is usually no obligation on the Lenders to notify the Borrower when they have entered into a CDS. Although in some cases the Borrower knows about the CDS from the outset, more usually it would not, nor have any contractual right to do so; the only exception would be if physical settlement required the Borrower's consent, or consultation with it.

Confidentiality

The information provided by Borrowers to their Lenders may be disclosed to the Sellers of CDS. Lenders are permitted by the LMA documentation (which reflects market practice in this regard) to disclose any appropriate information received from the Borrower to any person with whom they enter a CDS, or may do so. A confidentiality undertaking is usually required. As the LMA present this merely as an option, Borrowers need to insist on it.

The Seller will need information from the Borrower, for the purposes of pricing, at the time of the trade. However, practice seems to vary with regard to information flow thereafter. A call for settlement requires the provision of only publicly available information, and indeed because of the need to avoid any possible market abuse, some Sellers may not be able to receive material non-public information ("MNPI"). However, in certain circumstances, other Sellers may be entitled to receive MNPI from the Buyer, subject to the provision of a confidentiality undertaking.

Voting

Depending on the terms agreed, the Seller may have the right to instruct the Buyer as to how to vote. Typically, however, voting rights remain with the Buyer until the process of physical settlement begins, when control of voting rights will pass to the Seller.

Potential issues and strategies for Borrowers in relation to CDS: in general

While the Borrower is able to comply with its covenants, it is unlikely to be troubled by a Lender's CDS cover.

A Lender's CDS cover can however become a problem for a Borrower facing financial difficulties. Press coverage of this issue over recent months has reflected market concerns about the potential impact of credit derivatives on restructurings. There have not been many major restructurings in the last few years, and of these only a few have been affected by credit derivatives. It is not suggested that CDS have to date caused an otherwise viable restructuring to fail. However the recent explosive growth in credit derivatives has focussed concern that, in an economic downturn, credit derivatives may "damage the timeliness and effectiveness of workouts following credit events and could, in an extreme scenario, undermine an otherwise viable restructuring" (FSA, November 2006).

In general, therefore, Borrowers need to be aware that the existence of CDS cover may affect the response of Lenders to restructuring negotiations, and dictate their approach to the structure and terms put forward.

Potential issues and strategies for Borrowers in relation to CDS: specific points

Possible Credit Event

A covered Lender presented with a request to waive an Event of Default, or amend the facility agreement, may be influenced by its assessment as to whether and when a Credit Event may occur.

Where a Credit Event appears remote, the Lender is unlikely to be influenced by its CDS cover in deciding whether or not to approve the request, though the existence of the protection could lead it not to respond. Against this eventuality, Borrowers might want a "snooze and lose" provision, as discussed in Part 1.

Where a Credit Event is probable, or at least foreseeable, the Lender is bound to be aware of the advantage to it in the occurrence of the Credit Event. Rather than being motivated to work with the Borrower to settle a waiver or amendment, or even a workout, the Lender may have an interest in the occurrence of the Credit Event: on the occurrence of a Credit Event, it can call for settlement.

This potential problem should not be exaggerated. In practice it is rare for a Lender to cover the whole of its exposure. The fact that a portion of its exposure is uncovered may mean that, to that extent, the Lender retains an economic interest in the successful outcome of the restructuring.

In these circumstances, however, the invisibility of the CDS presents the greatest threat to a Borrower. In its efforts to formulate a restructuring plan which will meet with the approval of its creditors, it is likely to be frustrated by the fact that it does not know, and has no contractual entitlement to find out, what, if any, CDS protection is held by its Lenders, and what the terms of that protection are. If it could discover this information, it would have a greater chance of putting together a proposal which would satisfy the demands of its creditors. These difficulties are well attested, notably in the case of Marconi (see box below).

Marconi

In the Marconi restructuring, it was discovered at a relatively late stage that the reason that some of the banks would not agree to extend the syndicated facility beyond its maturity was that they would not then have the protection of their CDS. While supportive of the restructuring in principle, they were concerned to benefit from their CDS. However, for most of the many months of negotiations, no Credit Event occurred, nor was likely to occur, the aim being precisely to avoid that eventuality. There was no contractual obligation on the Lenders to disclose existence of their CDS, or the names of the sellers. The lack of information about the CDS and the identity of the providers made it extremely difficult to formulate proposals that would be likely to be acceptable, and the absence of dialogue with the ultimate holders of the credit risk was clearly a serious threat to the prospects of success for the restructuring. In the end, there was very little time between the Credit Event which finally occurred and the voting on the restructuring proposals, for delivery of the bank debt to the CDS providers.

Possible disclosure obligation

In today's market, Borrowers may wish to discuss these potential difficulties with their lending syndicates, before signing. It is possible that a limited disclosure obligation could be framed in a way that is acceptable to Lenders and at the same time assures Borrowers of some information which might enable them to formulate a proposal requiring a vote in a way which might maximise the chances of approval.

Pointing to the proven difficulties of securing a rescue without adequate information (see box above), Borrowers may be able to justify a request for a disclosure obligation as being in the interests of all. The interests of a Lender with CDS protection will not always be best served by allowing a Credit Event to occur.

The value of a disclosure obligation would be limited, as a snapshot of the facts on the date a disclosure is made. A Lender could sell its protection as soon as it had disclosed its existence. The likelihood of this happening would have to be assessed. It would be important to appreciate also that the interests of covered Lenders will differ, depending on the terms of their protection.

In order to be acceptable to Lenders, a disclosure obligation would have to be limited and conditional. One issue would be the trigger for the obligation. Since the purpose would be to facilitate the formulation of a plan to avoid a Credit Event, the disclosure obligation might perhaps triggered by a request from the Agent following notification of an Event of Default.

It may also be necessary to take account of confidentiality obligations between the parties to a credit derivative, which could prevent disclosure to the Borrower.

Market practice currently does not involve the Lenders in giving any undertaking of this kind. For many Lenders the invisibility of the protection afforded by CDS may be paramount: as explained above, the Borrower usually does not know of them, nor have the right to find out, and this is a feature of credit derivatives which makes them attractive to Lenders. Some Lenders may also feel that disclosure could reveal risk management techniques to competitors. For other Lenders, however, a disclosure obligation relating to a practice widely regarded as a norm may not be unacceptable.

In the current climate, a request for a disclosure obligation may be expected to have some prospect of success. A guidance booklet published by INSOL International in 2006 ("Credit Derivatives in Restructurings") highlights the risks posed to a restructuring by credit derivatives, advising that "Where problems arise, their resolution will be assisted by awareness of the potential risks, efforts (particularly by the debtor) to identify important players and understand their positions, and careful planning" (2.8). Notably, this view is quoted approvingly by ISDA in their response of 6.3.07 to the FSA Discussion Paper 06/6 (Private equity: a discussion of risk and regulatory engagement).

Term of CDS cover

Lenders with CDS are liable to oppose a request to extend the term of a credit facility, as the swap is set for a fixed period, after which the protection ceases. This was a problem for Marconi (see box above) which might have been reduced, if the company had been able to identify whether the majority of their Lenders were protected, and the relevant period.

Termination of CDS

European LCDS currently terminate on prepayment of the loan in full. As a result, on a restructuring, covered Lenders are likely to refuse a waiver or amendment involving a prepayment if as a consequence their protection terminates. GUS encountered the same problem with its CDS holders, in the context of a redemption of its bonds, as the Treasurer highlighted in February 2007.

This problem could also be avoided, or at least reduced, if it were possible to identify the Lenders' cover in advance.

It is worth noting that the position under European CDS and Leveraged LCDS contrasts with that in the US, which includes a mechanism for substitution of a reference obligation. ISDA is currently working on new documentation which would address this discrepancy. The latest proposal involves a "continuity option".

Physical settlement: voting

On physical settlement of CDS, the Lender may transfer its loan participation to the Seller, subject to applicable restrictions. The Seller may thus become the new Lender, with voting rights from the start of the settlement process. Although the new Lender may sell promptly to a third party, it may wish to remain through the restructuring process.
The need to bear in mind the possible effect of a new syndicate member on any forthcoming vote highlights the Borrower's need to be informed about loan transfers, if not to have a right of veto, or to be consulted, as discussed in Part 1.

Possible Borrower action: summary

While bearing in mind the improvements in liquidity and pricing that accrue from the development of the credit derivatives market:

- Borrowers need to **be aware** that the existence of CDS cover may affect the response of Lenders to a request for a waiver or amendment, or restructuring negotiations, and dictate their approach to the structure and terms put forward.
- Borrowers should consider asking the Lenders to undertake a limited **disclosure obligation**, focussing on "single name" credit derivatives. This could be triggered, for example, by a request from the Agent following notification of an Event of Default. It may be necessary to take account of confidentiality obligations between the parties to a credit derivative, which could prevent disclosure.
- There may be circumstances in which it might be justifiable for a Borrower to restrict the Lenders' ability to enter into "single name" credit derivatives or sub-participations, so that

its prior **consent** is required. Although not market practice, this is known to have been achieved in some cases.

- Borrowers need also to ensure that Lenders are required to obtain **confidentiality undertakings** before disclosing any information provided by them to CDS counterparties.
- To guard against a Lender failing to respond to a request, Borrowers may want a "**snooze and lose"** provision, disenfranchising the Lender in question where it fails to respond (as discussed in Part 1).
- Finally, the possibility of transfer of the loan participation to a third party as a result of settlement of a CDS underlines the need for Borrowers to focus on **restrictions on transfer** (as discussed in Part 1).

In the current climate, these are all topical issues for Borrowers to discuss with their Arrangers.