Loans & Secured Financing 2022

Contributing editor
Michael Chernick
Shearman & Sterling LLP

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KEY CONTACTS

Michael Chernick
Partner
michael.chernick@shearman.com
+1 212 848 5281

Maura O'Sullivan
Partner
mosullivan@shearman.com
+1 212 848 7897

Alan Rockwell
Partner
alan.rockwell@shearman.com
+1 212 848 5280

shearman.com

Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development manager
Adam Sargent
adam.sargent@gettingthedealthrough.com

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Lexology Getting The Deal Through is delighted to publish the seventh edition of *Loans & Secured Financing*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on United States, Mexico, Bahamas and Cyprus.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Michael Chernick of Shearman & Sterling LLP, for his assistance with this volume.

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Global overview

Michael Chernick
Shearman & Sterling

The US Federal Reserve has continued to maintain its focus on the origination and maintenance of leveraged loans. In the aftermath of the global financial crisis of 2007–2008, in March 2013, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation jointly issued the Interagency Guidance on Leveraged Lending (the Guidance). The Guidance was designed to curb unsafe lending practices by banks and other regulated lending entities by establishing standards for leveraged lending. In November 2014, the Guidance was supplemented and reiterated, sending a message to banks that regulators were serious about enforcing it. Among other pronouncements, the supplemented Guidance cautioned that leveraged loans that resulted in a debtor having a total debt-to-EBITDA ratio in excess of six or, more generally, not having the ability to repay its debts over five to seven years, would be much more likely to result in criticism by regulators. This statement led to a higher degree of reluctance by banks and other regulated entities to make highly levered loans, which allowed non-bank lenders and foreign banks not subject to this regulatory regime to increase their market share in the leveraged finance market.

However, in October 2017, the Government Accountability Office (GAO) determined that the Guidance was a rule, rather than a general statement of policy, under the Congressional Review Act (CRA). Because the CRA requires rules to be submitted to Congress for review, and the Guidance was never submitted, the GAO's decision meant that the Guidance was not in effect. In response to this decision, in February 2018, the Federal Reserve and the Office of the Comptroller of the Currency issued separate statements acknowledging that the Guidance was non-binding. The regulators further indicated that they would consider reopening the Guidance for comment, which could mean changes to the leveraged loan regulatory framework, including a formal repeal of the Guidance, in the coming years.

Although the regulators have not recently made any significant changes relating to the Guidance, a number of prominent economists including Federal Reserve chair Jerome Powell and former Federal Reserve Chair Janet Yellen, as well as politicians including Senator Elizabeth Warren, among others warned about the potential negative impact on the economy of higher leveraged businesses borrowing excessive debt during a weaker economy and that high levels of corporate debt could exacerbate future economic downturns and instigate a deeper recession. After the covid-19 shock in March 2020, loans suffered record downgrades and increased defaults. However, as the year progressed, although the regulators remained cautious, as of late 2020, they had not found that leveraged lending presented significant threats to financial stability. Based on these assessments, such regulators determined that leveraged lending activities had not contributed significantly to the distress of any large financial entity whose failure could threaten a larger scale financial instability. They found that large banks' strong capital positions have allowed them to manage their leveraged lending exposures.

The leveraged loan market experienced a volatile 2020, starting the year strongly but experiencing a severe downturn for several months, principally as a result of the covid-19 pandemic, and then ending the year, in particular in the US, on a much stronger note. According to Standard and Poor's Leveraged Commentary and Data (S&P LCD), total institutional loan volume in the US for 2020 was approximately $288 billion, a decline of approximately 7 per cent from the levels for 2019, and the institutional European primary loan issuance market in 2020 was approximately €51.7 billion a decline of approximately 26 per cent of 2019 levels. In 2020, investment-grade lending was down by about 36 per cent, to $606 billion, compared to 2019 levels according to Refinitiv although some of that decline was likely offset by a significant increase in the issuance of investment-grade corporate bonds. In contrast, the high-yield bond markets had a stellar 2020, coming in at approximately $435 billion for the year according to S&P LCD (the most of any calendar year) increasing from $253 billion in 2019. In particular, the Federal Reserve's expansion of its safety net to include recent fallen angels helped to propel such record issuance. The lower levels of leveraged loan activity in the US was driven primarily by significantly lower M&A and leveraged buyout activity, which at approximately $147 billion was the lowest since 2012 and a decline of 47 per cent from the record levels of 2018 according to S&P LCD, due to a number of factors including economic uncertainty due in large part to the covid-19 pandemic, political uncertainty and high corporate valuations.

Despite the reduction in the amount of leveraged loans in 2020, the Shared National Credits Program 1st Quarter and 3rd Quarter 2020 Reviews (the 2020 SNC Review), reported that leveraged loans continued to account for a large percentage of riskier loans on the market. According to the 2020 SNC Review, special mention and classified SNC commitments rose significantly from 6.9 per cent in 2019 to 12.4 per cent in 2020. Approximately 48 per cent of the total SNC commitments, 66 per cent of special mention commitments and 78 per cent of classified commitments were agent bank identified leveraged loan commitments according to the 2020 SNC Review. Economic stresses brought on by covid-19 had a material adverse impact on obligors within the SNC population of borrowers as the level of risk on these borrowers was magnified in leveraged lending transactions in which the obligor was operating in a covid-19 impacted industry as the special mention and classified rate in this segment rose from 13.5 per cent in 2019 to 29.2 per cent in 2020. Such industries included real estate, travel and leisure, transportation services, retail and oil and gas. Although underwriting and risk management practices, especially on the part of US banks, have shown improvement since 2014, the level of commitments rated special mention and classified by shared national credits' (SNC) examiners continued to be higher than that observed in previous periods of economic expansion. The 2020 SNC Review observed that the risks associated with leveraged lending activities, enabled by strong investor demand, continue to build as many leveraged loan transactions possess weakened transaction structures, aggressive repayment assumptions, weakened covenants or permissive borrowing terms that

allow borrowers to draw on incremental and junior facilities to further increase debt levels.

Banks, however, do not account for the bulk of these riskier loans. On the contrary, non-bank financial institutions, including private equity firms, continued to be the primary holders of riskier, leveraged loans, accounting for 55.4 per cent of the special mention and classified loans in the 2020 SNC portfolio, compared to 24.4 per cent held by US banks and 20.2 per cent held by foreign bank organisations.

Nonetheless, in the years following the financial crisis, banks have worked towards improving their risk management and measurement practices, as well as their overall capital and liquidity positions. Regulators continued to check these measures in 2020 through stress tests, and in the United States, they have announced that they intend to focus particularly on exposure to leveraged lending and credit risk on future stress tests.

To fill the void in the leveraged loan market left by the partial departure of traditional banks, investors have continued to turn to non-bank financial institutions, which are not subject to the Guidance and are largely unregulated. As institutional investors make up more of the leveraged loan market, the use of covenant-lite loans, which do not contain financial maintenance covenants and have flexible operating covenants similar to high-yield bond covenants, have continued to flourish. This increase has been driven, in large part, by private equity groups performing leveraged buyouts and a borrower-friendly loan market.

While the growth of this 'shadow banking' system in the United States seems to have been aided by the pronouncement of the Guidance, such growth began prior to 2013. The growth has been due in part to the declining presence of banks in middle-market lending as many of the regional banks that focused on that business consolidated and merged with larger financial institutions that focused less on lending to small and medium-sized businesses. According to the IMF, the non-bank share of leveraged lending in the United States rose from approximately 20 per cent in 2000 to approximately 80 per cent in 2013 – a response to strengthened regulation of US banks over the years, particularly after the 2007/2008 financial crisis. According to a Refinitiv estimate, the total US direct lending market had grown to around $800 billion in 2020.

This phenomenon is not isolated to the United States. As the shadow banking industry developed and received increased attention from global leaders, the FSB announced its decision in 2018 to replace the term 'shadow banking' with 'non-bank financial intermediation' to emphasise the forward-looking nature of the FSB's work to enhance the resilience and understanding of the non-bank financial intermediation industry. The key drivers of this worldwide growth in shadow banking or non-bank financial intermediation, as noted by the IMF, can be attributed to tightened banking regulation, ample liquidity conditions, demand from institutional investors, low real interest rates and a compression of term spreads. It is unclear whether the shift of lending from traditional banking to shadow banking will lead to a rise or reduction in overall systemic risk; however, market and liquidity risks have risen.

According to data from Debtwire Par, covenant-lite leveraged loan issuances in the United States continue to account for over 80 per cent of all volume, compared to just approximately 15 per cent at the end of 2008. Demand for covenant-lite loans is also increasing outside the United States, especially in Europe and Asia. S&P LCD approximated that 94 per cent of European global leveraged loans in 2020 were covenant-lite, compared to 51 per cent in 2015 and zero in 2011.

The demand for covenant-lite loans in the European leveraged loan market has been largely driven by low interest rates and the need for the European bank loan market to become more competitive with the high-yield market and the US bank loan market, as European borrowers have increased their exposure to the US leveraged loan market in search of cheaper prices and more favourable covenant packages. Given the bond market's relative illiquidity and issuer-friendly covenant-lite loans, term loan products have accordingly started to overtake high-yield bond issues in Europe. The longer-term shift from a market in which creditors were predominantly banks to a market dominated by institutional investors, including private equity and pension fund sponsors, which have neither the resources nor the interest in micromanaging debtors through restrictive covenants, has also driven up demand for covenant-lite loans in Europe. In combination with these demand-side factors, there is not enough supply of European loans to satisfy investors owing to reduced activities by European investment banks in originating leveraged loans as a result of regulation and capital cost issues.

To address the rise of leveraged loans and the use of riskier covenant-lite loans, in May 2017, the European Central Bank (ECB) published its own guidance on leveraged transactions, which is aligned with the standards set in the US guidance. The ECB's guidance outlines expectations regarding the risk management and reporting requirements for leveraged transactions for all significant credit institutions supervised by the ECB. Similar to the US guidance, debt-to-EBITDA ratios in excess of six should remain rare, and covenant structures presenting weak features should be monitored. The direct impact from the ECB guidance, which came into effect in November 2017, remains to be seen. Although default rates on leveraged loans remain at near historic lows (although a bit higher than over the past couple of years as a result of the covid-19 pandemic), various agencies around the world, including the Federal Reserve, the ECB and the IMF, have cautioned against the development and use of leveraged finance and covenant-lite loans and have urged for greater scrutiny of these riskier loans.

In the United States, investor demand has allowed loan documentation to develop additional borrower-friendly characteristics, in addition to being covenant-lite. Commonly negotiated points include permissive cost savings and revenue synergy adjustments to EBITDA, as well as more flexible incremental provisions (including financial ratio-based baskets, the ability to incur side-car facilities (which are stand-alone credit facilities secured on a pari passu basis with the existing credit facility) and acquisition debt carve-outs to the limitations on incremental facility pricing and maturities).

The year 2020 was extraordinary for many reasons. There were many events that had a significant impact on the global economy, some of which were predictable, including the US presidential election and the uncertainty surrounding Brexit but nobody could have predicted a world-wide pandemic that would shut down important sectors of the global economy for significant periods of time. For many borrowers, the covid-19 pandemic has had, and continues to have significant implications on all aspects of their business, including on their ability to comply with the covenants in their debt facilities.

Initially, one of the first impacts of the covid-19 pandemic was the focus by borrowers on their liquidity and shoring up their balance sheets so their businesses had adequate cash on hand to continue operations in an environment where revenues were sharply reduced and there was significant uncertainty as to the duration of the pandemic and the ultimate impact it would have on their businesses. During March and April 2020, there was a material increase in borrowings under working capital revolving facilities even from borrowers who historically have not tapped such facilities for liquidity. As markets stabilised, many of these companies were able to raise additional capital through bond sales or longer-term credit facilities and pay down their revolving credit facilities. According to Dealogic, companies raised over $900 billion in capital through US bond sales between 1 April and 31 August 2020, which was more than double the volume for the same period in 2019.

For many borrowers, the first interplay between the covid-19 pandemic and the loan markets involved determining whether they would be able to draw on their revolving facility. The key conditions that

a borrower must usually satisfy in order to borrow under these types of facilities are (1) there being no default or event of default and (2) that the representations and warranties in the loan documentation are true and correct, in each case, on the date of, and after giving effect to, such borrowing. The impact of the pandemic could affect the ability of a borrower to make several customary representations and warranties including as to the solvency of the business but the one representation that is in most credit agreements that borrowers and lenders focused on is the 'material adverse effect' (or 'material adverse change') representation. Initially, there were numerous questions raised by market participants as to whether the covid-19 pandemic should be deemed a 'material adverse effect' with respect to a borrower but lenders generally honoured these borrowing requests, even those made by borrowers whose businesses were meaningfully impacted by the pandemic.

In addition to the liquidity challenges many businesses faced, many borrowers also needed to address their ability to comply with their credit agreements as a result of the impact of the covid-19 pandemic. These borrowers were faced with the prospect of having to increase their leverage to raise cash to pay ongoing expenses while also knowing that they would be generating lower EBITDA for an indeterminate period of time. Many of them elected to engage in discussions with their lenders seeking covenant and other forms of relief from provisions in their debt instruments. Such relief included:

- obtaining financial maintenance covenant relief either in the form of holidays or the loosening of levels;
- permitting more time to obtain to deliver periodic financial statements and in particular audited financial statements as auditors and businesses alike had trouble meeting deadlines in the face of government stay at home orders;
- modifying EBITDA definitions to include covid-19 specific add-backs or setting EBITDA for specified periods with historical EBITDA amounts;
- permitting borrowers to incur additional debt under governmental programmes, such as the Small Business Administration's Paycheck Protection Program or the Federal Reserve's Mainstreet Lending Program; and
- allowing interest to be paid in kind or waiving certain mandatory prepayment requirements.

Generally, lenders were willing to work with their borrower clients in allowing them the relief they sought but in return they often sought concessions, which included increased pricing and/or fees, increased reporting, minimum liquidity maintenance covenants and the tightening of a number of the restrictive covenants, including debt and lien incurrences as well as the making of investments and restricted payments.

In addition to the issues described above, for certain borrowers the relief described was inadequate to meet their needs during this period. To address these circumstances, these borrowers engaged in more aggressive transactions commonly known as liability management transactions. Although there are a number of different types of transactions, the most common ones that were employed in 2020 were 'dropdown financings' and 'uptiering transactions'. In dropdown financings, the borrower would transfer assets to either a non-guarantor restricted subsidiary or an unrestricted subsidiary in which case the liens on such assets would be released. The transferee of such assets would then be able to incur new debt that would be secured by such assets, and those lenders would have a senior claim on such assets. In an uptiering transaction, the borrower would offer lenders under a new facility claims against existing guarantors and/or the collateral package that is contractually senior (usually through lien priority) to the claims of the existing lenders.

Although the leveraged lending market did have a down year in 2020 due in large part to the covid-19 pandemic, it showed a lot of resiliency and in particular in industry sectors that were not as heavily impacted by the pandemic as others.

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KEY CONTACTS

Michael Chernick
Partner
michael.chernick@shearman.com
+1 212 848 5281

Maura O'Sullivan
Partner
mosullivan@shearman.com
+1 212 848 7897

Alan Rockwell
Partner
alan.rockwell@shearman.com
+1 212 848 5280

shearman.com

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