LMA | Loan Market Association

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Dear Sirs

Consultation Paper - Draft Guidelines on loan origination and monitoring (the "Consultation")

We write to you further to publication of the Consultation and your request for feedback in respect of the proposals contained therein.

We have set out our responses to a number of the questions posed by the Consultation below:

Question 1: What are the respondents' views on the scope of application of the draft guidelines?

The Loan Market Association (the "**LMA**") welcomes the opportunity to provide feedback in relation to the EBA Consultation Paper, *'Draft Guidelines on loan origination and monitoring'* (the "**EBA Guidelines**"). ***For further details about the work carried out by the LMA, please see Appendix 1 (Loan Market Association).***

The LMA recognises the positive regulatory intent behind the EBA Guidelines, in particular the need to tackle non-performing exposures ("**NPEs**") within the loan market. The LMA is aware of the negative impact of NPEs on liquidity in both primary and secondary syndicated loan markets, and welcomes positive action by the EBA to reduce the volume of NPEs.

Given the maturity of the syndicated lending market, most financial institutions which operate in this market are already, to the extent applicable, applying the requirements set out in the EBA Guidelines within their existing practices and associated governance arrangements, processes and mechanisms in relation to the origination and monitoring of syndicated loans. This is on the basis that the syndicated loan market is a well-functioning, organised professional market, often international and cross-border in nature, which provides much of the capital used by some of the largest companies in the world for a variety of purposes including in relation to acquisitions, projects, real estate, infrastructure, shipping, aircraft and structured trade and commodity finance. ***A more detailed overview of syndicated lending is provided at Appendix 2 (Syndicated Lending).***

Therefore, whilst recognising and supporting the rationale for the production of the EBA Guidelines, given the nature of syndicated lending and its breadth across a wide variety of sectors and jurisdictions, the LMA has some concerns about the generic scope of their application. In particular, the LMA is keen to emphasise that the EBA Guidelines must be flexible enough to accommodate the full and varied spectrum of transactions, sectors and borrowers which operate within the syndicated loan market. Regard should also be had to the importance of product flexibility. Borrowers across a broad range of sectors rely on the flexibility of the syndicated loan product for a variety of different reasons but, in particular, to ensure that the finance provided is suitable to the nature of their business and the jurisdictions in which they operate. Overly prescriptive guidelines consequently have the potential to create barriers to entry for viable borrowers to this important source of financing. In the context of immoveable property, for example, certain real estate finance transactions will require a

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nuanced approach to be taken on account of the nature of the underlying property or development in question. Please see our response to question 11 for more details. The LMA therefore suggests the inclusion of a statement at paragraph 13 of the EBA Guidelines which recognises that competent authorities may also take into account the nature of the borrower, the purpose of the financing and/or of any collateral provided to lenders in their application of the EBA Guidelines.

Similarly, it is noted that the EBA Guidelines take a granular approach which may encourage a prescriptive or "tick-box" approach to risk management by financial institutions. Whilst this may be appropriate for certain vanilla loan transactions, financial institutions should be encouraged to carry out a full risk assessment that is appropriate to the specific nature of the underlying deal structure. Therefore, the LMA recommends that the EBA Guidelines should also include a statement which expressly recognises that financial institutions may diverge from a strict application of the EBA Guidelines in circumstances where the underlying transaction requires it. Such a statement will also help to ensure that different competent authorities do not take conflicting approaches when considering subsequent domestic application of the Guidelines – something that is particularly important given the cross-border nature of many syndicated loan financings.

In addition, the LMA believes that the EBA Guidelines may, albeit unintentionally, create issues for lenders in certain instances where they provide that lenders must 'ensure' the achievement of a particular outcome. For example, paragraph 199 provides that:

"Institutions should ensure that the valuers provide an impartial, clear, transparent and objective valuation, and each valuation should have a final report providing the necessary information on the valuation process and property."

In this particular example, whilst lenders may be able to take reasonable steps to ensure that a valuer acts in an impartial manner, the actual behaviour of the valuer will be outside a lender's control. Consequently, the LMA recommends that the requirement at paragraph 199, together with any other absolute requirements relating to third party actions, should be re-worded to provide that lenders will use reasonable endeavours to achieve any such outcomes, as is appropriate having regard to the nature of the borrower and the transaction/collateral in question.

Finally, the LMA is concerned that the use of the word 'professional', which is used within the EBA Guidelines to refer to loans to 'non-consumers', may lead to confusion amongst lenders about the scope of the EBA Guidelines since the word 'professional' has a particular meaning under the Markets in Financial Instruments Directive. As such, our recommendation is that references to loans to 'professionals' should be deleted and replaced by references to loans to 'non-consumers', and this definition should expressly exclude all retail customers.

Question 2: Do you see any significant obstacles to the implementation of the guidelines by the application date and if so, what are they?

It is noted that the EBA Guidelines are intended to apply from 30 June 2020 onwards. Bearing in mind the Guidelines cover both retail and wholesale markets, the LMA is concerned that this deadline does not allow sufficient time for institutions to fully digest and implement them across all relevant product areas. In order to identify gaps in existing policies, banks will need to carry out a wholesale review of existing policies and practices to ensure compliance with the EBA Guidelines. The LMA, therefore, recommends that a grace period should be introduced for implementation in relation to new loans so as to allow institutions time to ensure full compliance.

The EBA's cost-benefit analysis/impact assessment at page 77 of the EBA Guidelines provides that the broader application of the EBA Guidelines to both new loans and loans originated prior to the implementation of the EBA Guidelines is expected to result in, "*limited additional costs... as the amendment on internal practices, policies, processes and procedures of institutions and supervisory practices will be carried out for new loan originations and can accordingly be applied to existing loans.*" Whilst it is recognised that, in certain cases, there may be a limited cost associated with the application of the EBA Guidelines to legacy loans, the analysis at page 77 overlooks the fact that the divestment of any non-compliant loans from legacy loan books could create substantial issues for lenders and borrowers alike. The application of the EBA Guidelines to all loans originated before the date of the implementation of the EBA Guidelines (including the refinancing of such loans) will require the amendment or divestment of non-compliant facility agreements. This process is likely to require significant time and cost to be inputted by lenders. Accordingly, the LMA suggests that the analysis at page 77 should be reconsidered and provisions should be introduced for the 'grandfathering' of existing loans. For the same reasons, the requirement for full compliance should not be triggered by reason of amendments being made to legacy loans.

Question 3: What are the respondents' views on whether the requirements set in the draft guidelines are future proof, in particular in relation to technology enabled innovation (Section 4.3.2) and environmental factors and green lending (Section 4.3.3)?

ESG Factors

The LMA understands that one of the key objectives of the EU Commission's Action Plan on Sustainable Finance is to manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues. The significant role that the European Supervisory Authorities (including the EBA) have been mandated with as part of the Action Plan, including identifying and reporting on the risks that sustainability factors pose to financial stability, is recognised. The LMA also acknowledges the fact that the proper recognition and management of ESG risks will be an important factor in ensuring continued liquidity in primary and secondary loan markets going forward.

It is noted that under Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending the Capital Requirements Directive IV as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures ("**CRD V**"), the EBA is due to report to the Commission, the European Parliament and the Council by 28 June 2021 on its assessment of the potential inclusion of ESG risks in the review and evaluation of institutions performed by competent authorities. The EBA's assessment is required to comprise at least the following: (i) the development of a uniform definition of ESG risks, including physical risks and transition risks; (ii) the development of appropriate qualitative and quantitative criteria for the assessment of the impact of ESG risks on the financial stability of institutions in the short, medium and long term; (iii) assessment of the arrangements, processes, mechanisms and strategies to be implemented by institutions to identify, assess and manage ESG risks; and (iv) the analysis methods and tools to be used to assess the impact of ESG risks on lending and financial intermediation activities of institutions (together being the "**ESG Criteria**"). CRD V also provides that the EBA may, if appropriate, issue guidelines, in accordance with Article 16 of Regulation (EU) No 1093/2010, regarding the uniform inclusion of ESG risks in the supervisory review and evaluation process performed by competent authorities.

The LMA understands that the rationale for seeking to introduce ESG factors into risk management policies, credit risk policies and procedures is to ensure that institutions take ESG risks adequately into

account and, thereby, avoid or mitigate financial losses, reputational risks, and social and environmental harm. The LMA is aware that certain national regulatory bodies are already asking banks to consider the financial risks posed by climate change through their existing risk management frameworks. However, further guidance is needed in a number of areas, particularly around the ESG Criteria, to ensure that consistent national standards develop in this area.

In addition, there are currently issues with the reliability and availability of data and associated methodologies relating to ESG risks, which may hinder or prevent banks from carrying out a complete assessment of ESG risk factors. Accordingly, the LMA recommends that the EBA Guidelines at paragraph 48 may be better addressed when, and if, the EBA decides to issue guidelines following its assessment under CRD V. By issuing this more detailed guidance, the EBA will better ensure the development of consistent and harmonised national supervisory regimes relating to the incorporation of ESG risks into institutions' risk management policies, credit risk policies and procedures. Further, the EBA Guidelines at paragraph 48 should be expressed to apply only "where appropriate" and it should be clearly stated that the EBA Guidelines at paragraph 48 should be applied in a manner which takes into consideration the evolving understanding of what best practice looks like in relation to the assessment of ESG risks.

Green Lending

The LMA is very much committed to supporting the development of green and sustainable finance.

In March 2018, the LMA, together with the Asia Pacific Loan Market Association ("**APLMA**"), launched the Green Loan Principles ("**GLP**") with the support of the International Capital Market Association. The publication of the GLP marked an important step towards establishing widely accepted principles in the green loan market. The EBA Guidelines at paragraph 49 are consistent with the GLP and the LMA welcomes the flexibility that the EBA Guidelines offer for this loan product's continued growth.

Efforts to drive green and sustainable finance need to be clearly coordinated on an international level to ensure that a harmonised framework develops across different jurisdictions. If regulation in this area is developed in an ad-hoc manner, we are concerned that this could stifle the development of green and sustainable finance products and create barriers to entry for new entrants to this market. The LMA encourages the EBA to continue to work with competent authorities and other bodies, including through its membership of The Network for Greening the Financial System, to support the continued growth of the market for green and sustainable finance products by ensuring that harmonised regulatory frameworks emerge which are designed to help these innovative products to continue to grow and evolve.

In relation to paragraph 49a, the EBA Guidelines should recognise that there is still much uncertainty as to what constitutes a 'green project' within the green loan market. Whilst the recent publication of the EU Technical Expert Group on Sustainable Finance's '*Taxonomy Technical Report*' (the "**EU Taxonomy**") will hopefully assist banks with setting criteria for those green projects eligible for funding, the EBA Guidelines should expressly recognise that this is an area where best practice is still developing, and any such list of projects is likely to be subject to change over time. Whilst neither compliance with the GLP nor the EU Taxonomy are mandatory, it may be helpful to include guidance within the EBA Guidelines to suggest that the alignment of green loan products with the GLP and/or the EU Taxonomy may be indicative of best practice by lenders in relation to green lending practices. The APLMA also strongly supports the inclusion of this statement in the EBA Guidelines.

In relation to paragraph 50 of the EBA Guidelines, the LMA understand that most, if not all, institutions that offer green lending products will already have overarching objectives, strategy and policy related to sustainable finance. However, further guidance is needed as to which qualitative or quantitative targets should be used to support the development and the integrity of green lending activity. As

above, the LMA understands that further guidance on the development of appropriate qualitative and quantitative criteria for the assessment of the impact of ESG risks will be included in the EBA's report under CRD V. As such, the LMA recommends that this guidance may more appropriately addressed as part of the guidance released following the EBA's complete CRD V assessment. Furthermore, the EBA Guidelines at paragraph 50 should be expressed to apply only "where appropriate" and it should be clearly stated that these guidelines should be applied in a manner which takes into consideration the evolving understanding of what best practice looks like in relation to the assessment of ESG risks.

Sustainability Linked Loan Products

Sustainability linked loans focus on improving the borrower's sustainability profile. The Sustainability Linked Loan Principles ("**SLLP**"), which the LMA prepared in March 2019 together with the APLMA and the LSTA, set out four core criteria for sustainability linked loans: (i) relationship to the borrower's overall corporate social responsibility strategy; (ii) target setting – measuring the sustainability of the borrower; (iii) reporting; and (iv) review. Unlike green loans, sustainability linked loans may be made available for general working capital purposes and are not limited to use for Green Projects. The sustainability linked loan market is, therefore, open to a wider range of borrowers across diverse industry sectors. Under the terms of a sustainability linked loan, the borrower is incentivised to improve its sustainability profile through the alignment of the loan terms (for example, the margin) with the borrower's performance against ambitious and meaningful pre-determined sustainability performance targets ("**SPTs**"). SPTs include key performance indicators, external ratings and/or equivalent metrics and measure improvements in the borrower's sustainability profile.

The EBA Guidelines make no reference to sustainability linked loan products. Given the recent sharp increase in volumes of sustainability linked loans in the market, the LMA recommends that the EBA should provide high level guidelines in relation to these loan products as well as green loan products. Again, in order to assist with the development of these products, the LMA encourages the EBA not to take an overly prescriptive approach. The LMA suggests that the EBA Guidelines should provide that alignment by lenders of sustainability linked loan products with the SLLP may be a good indicator of best practice in this area. The APLMA strongly supports the inclusion of such a statement in the EBA Guidelines.

Question 8: What are the respondents' views on the requirements for assessment of borrower's creditworthiness (Section 5.2)?

As mentioned in our response to question 3, there are still a number of gaps in the available data relating to ESG risks, which may create difficulties for institutions looking to carry out a complete assessment of the borrower's exposure to climate-related and environmental risks, as well as other ESG risks. As such, the EBA Guidelines should make it clear that this guidance applies only apply "where appropriate" or, otherwise, clearly state that the EBA Guidelines at paragraph 130 should be applied in a manner which takes into consideration the evolving understanding of what best practice looks like in relation to the assessment of ESG risks.

Question 11: What are the respondents' views on the requirements for valuation of immovable and movable property collateral (Section 7)?

Syndicated loan products are used to finance a range of immovable property collateral. Real estate assets are diverse, and each particular asset will have its own unique characteristics and associated risks. The LMA understands that the EBA Guidelines at Section 7, relating to the valuation of immovable property pledged, do largely reflect existing market practice. However, the LMA is

concerned that the EBA Guidelines in this section do not account for the nuanced approaches to valuation that may be required in relation to particular real estate assets or development projects.

Paragraph 195 suggests that "*institutions may consider using desktop or drive-by valuation approaches only in the cases of valuing or revaluing immovable property collateral (e.g. RRE and CRE) that is of similar design, specifications and characteristics to the ones already valued or re-valued by a valuer, e.g. similar apartments in the same apartment block*". The LMA understands that, particularly in relation to larger portfolio transactions, a sample of properties may be valued, as opposed to a valuation being carried out for each and every property in the portfolio. The EBA Guidelines should, therefore, be updated to reflect this relatively common approach to valuation.

Paragraph 196 of the EBA Guidelines provides that two sequential individual valuations of immoveable property by the same valuer should result in the appointment of either a different internal appraiser or a different external appraisal provider. It should be noted that the RICS Valuation – Global Standards 2017 (the "**Red Book**") suggest that it is considered good practice, albeit not mandatory, to rotate valuers at intervals not exceeding seven years. Accordingly, the requirements under the EBA Guidelines in relation to the rotation of valuers are more onerous than the Red Book requirements, and this may lead to additional costs for borrowers. Certain large development projects may, for example, require valuations to be carried out at frequent intervals. In this type of scenario, the requirement to change valuer part way through the process may be onerous, may add significant cost for borrowers and, furthermore, may risk the loss of significant knowledge held by the original valuer.

According to paragraph 158 of the EBA Guidelines, "*Institutions should assess and verify the borrower's experience in relation to the type, size and geographical location of the CRE*". It should be noted, however, that in a typical lending structure a borrower will be a special purpose vehicle which has been incorporated for the purpose of holding the immoveable property collateral. Typically, the borrower is not an operating company and does not have direct employees. As such, the borrower may have no direct experience of similar property dealings. The LMA suggests that it would be more appropriate to refer here to the experience of the borrower and/or its sponsors.

The EBA Guidelines provide at paragraph 194 that, "*At the point of origination institutions should ensure that the value of all immovable property collateral irrespective whether it is pledged against the loans to consumers or professionals is assessed by an independent qualified internal or external valuer.*" The use of the words, "whether it is pledged against the loans", is confusing in the context of English law since it is not possible to pledge real estate under English law. In addition, the LMA would not expect that a valuation will always be carried out if the property is not pledged as collateral for the relevant loan. As such, the LMA recommends the deletion of the words, "*irrespective whether it is pledged against the loans to consumers or professionals*" since this may lead to confusion amongst market participants and result in unnecessary costs for borrowers.

We would be happy to discuss any aspect of this response with you in more detail and to meet with you as required. If we can be of any further assistance, please do not hesitate to contact Nicholas Voisey via email at nicholas.voisey@lma.eu.com or by telephone on +44 207 006 5364.

Yours faithfully

Nicholas Voisey
Managing Director
Loan Market Association

Appendix 1 – Loan Market Association

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 730 organisations across 67 jurisdictions and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA is recognised across the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. Its overall mission is to act as the authoritative voice of the European loan market vis à vis lenders, borrowers, regulators and other interested parties.

Appendix 2 – Syndicated Lending

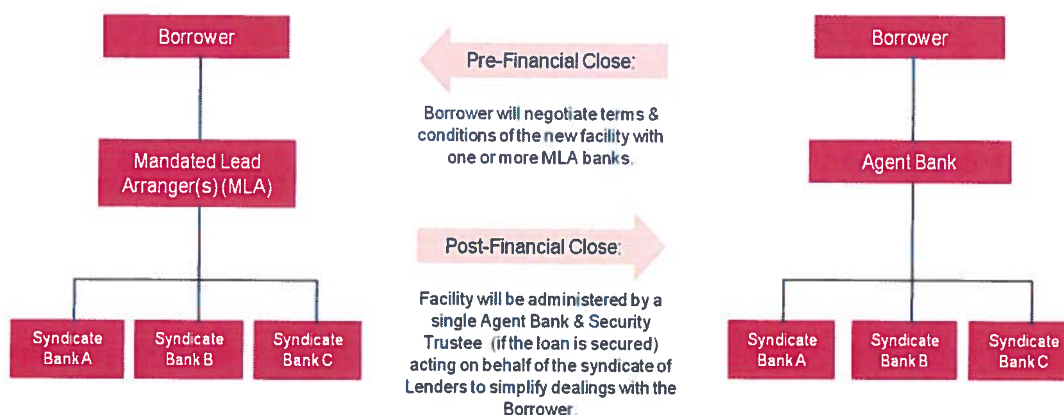
As mentioned above, the syndicated loan market is a well-functioning, organised professional market, often international and cross-border in nature, providing much of the capital used by some of the largest companies in the world for a variety of purposes.

A syndicated loan facility may encompass a single loan facility or a variety of different facilities, making up a total facility commitment (the "**Facility**"). Most commonly, this will constitute a term loan and/or a revolving credit facility, but may also include a swingline facility, standby facility, letter of credit facility, guarantee facility or other similar arrangements. Whilst the underlying instruments may differ, however, the structure of a syndicated loan is always the same - in each case, it involves two or more institutions contracting to provide credit to a particular borrower or group. Under a syndicated loan, the borrower or borrowing group (the "**Borrower**") will typically appoint one or more entities as "mandated lead arranger(s)" (the "**MLA**"). The MLAs will then proceed to sell down parts of the loan to other lenders (the "**Lenders**") in the primary market, whilst often retaining a proportion of the loan itself/themselves. The arrangement is put together under one set of terms and conditions (the "**Facility Documentation**"), usually following LMA recommended form facility documentation ("**LMA Facility Documentation**"), with each Lender's liability contractually limited to the amount of its participation. As a result, the syndicated loan market facilitates the sharing of credit risk, and it is therefore possible for a large number of Lenders to participate in facilities of various amounts, well in excess of the credit appetite of a single Lender. The syndicates themselves can range in size. Syndicates of only two to three Lenders are often referred to as "club loans".

To facilitate the process of administering the loan on a daily basis, one Lender from the syndicate (usually an MLA) will be appointed as facility agent (the "**Agent**").

Although some syndicated loan facilities are unsecured (particularly when such loans are extended to highly rated investment grade borrowers), the majority of mid-market, M&A, real estate, asset finance, structured trade and project finance syndicated lending is, in some way, secured against some or all of the assets of the Borrower and/or other group members. If the syndicated loan is to be secured, a Lender from the syndicate (usually also the Agent) will be appointed to act as a security trustee (the "**Security Trustee**"), to hold the security on trust for the benefit of a defined class of beneficiaries (i.e. the Lenders and any other finance parties with a security interest, such as hedge counterparties (together known as the "**Secured Finance Parties**")).

The following diagram illustrates the structure of a syndicated loan, both pre and post financial close of a transaction:



The origination and syndication of a syndicated loan transaction takes place in the primary market. Following final allocation of commitments in respect of the Facility to the Lenders, the Facility then

becomes "free to trade", subject to the terms and conditions contained in the Facility Documentation. The secondary loan market, therefore, refers to any sale of a loan by Lenders in the original syndicate ("**Seller**") or by a subsequent purchaser ("**Buyer**"). It should be noted that, whilst trading can take place as soon as the Facility becomes free to trade, such trades cannot be settled until the Seller becomes a Lender of record under the Facility Documentation.

A Lender may decide to sell its participation in a syndicated loan for a variety of reasons, including to realise capital, for risk management purposes, to meet regulatory capital requirements or to crystallise a loss. A Buyer, meanwhile, may wish to acquire/increase a commitment in a Facility, for example to develop/expand a Borrower relationship or simply for investment purposes.