SLAUGHTER AND MAY/

SEEDS OF CHANGE: LOAN FINANCING IN 2024

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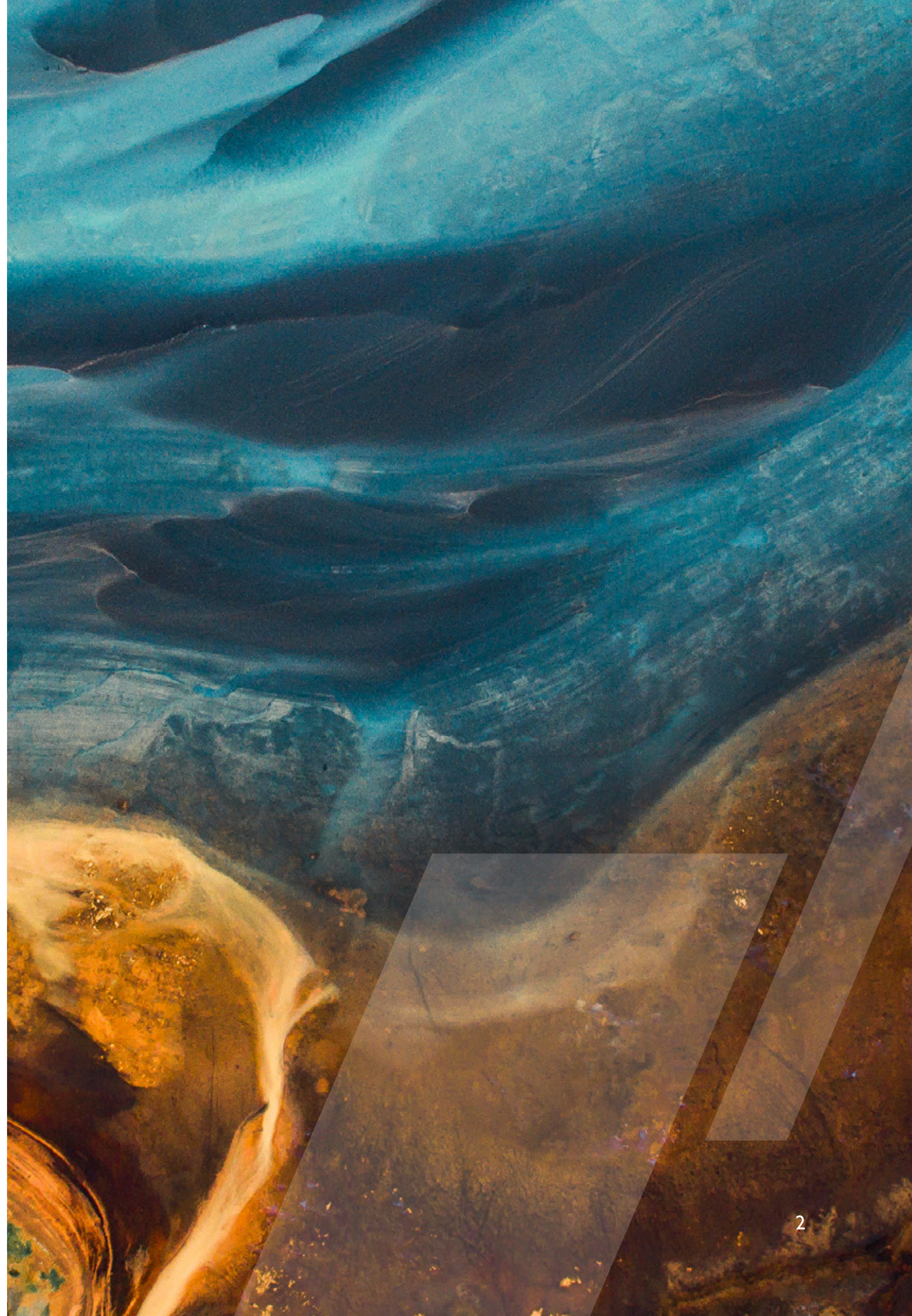

Liquidity was available for the right borrowers, but elevated funding costs, tight credit policies and geopolitical events dampened demand for M&A financing during 2023. General refinancing requirements were limited and for those needing to come to market, A&E solutions were preferred to full refinancings. These factors made the last year an exceptionally quiet one for the loan market.

Although tempered with now-familiar warnings of volatility, for businesses planning to re-enter the loan market in the next 12-24 months, sentiment appears more positive. Demand for loan financing is expected to be more robust in 2024 and beyond, in part due to the greater volumes of loans with impending maturities, but also prompted by anticipated reductions in funding costs (relative to recent levels) as inflation starts to decline, which may encourage an uptick in event-driven financings.

This briefing considers the near-term outlook for the loan market in terms of funding and liquidity, our views on whether the sustainability-linked loan market will return to growth, plus an indication of some other themes and topics that we expect to colour loan financing strategies and terms during 2024.

LIQUIDITY AND FUNDING COSTS

The lack of activity in the loan market during 2023 appears to have been due predominantly to increased cost of debt relative to historic levels rather than a lack of liquidity. Even for investment grade borrowers with compressed relationship margins, rising benchmark rates have made floating rate debt funding more expensive (even where hedged, as hedging agreed in the low-rate era rolls off and needs to be replaced). Funding costs have been a significant factor in the decline in M&A financing.

When inflation rates level out, the expectation is that key benchmark rates in the UK, Europe and the US will top out and fall, supporting a more positive outlook in terms of funding costs. While the key benchmarks currently remain relatively high, there is now some evidence of flattening (see across at Fig 1) and credit indices suggest that the pricing trends are heading downwards for borrowers across all credit brackets. Swap rates indicate downward movement going forward (see SONIA rates at Fig 2 overleaf, by way of example).

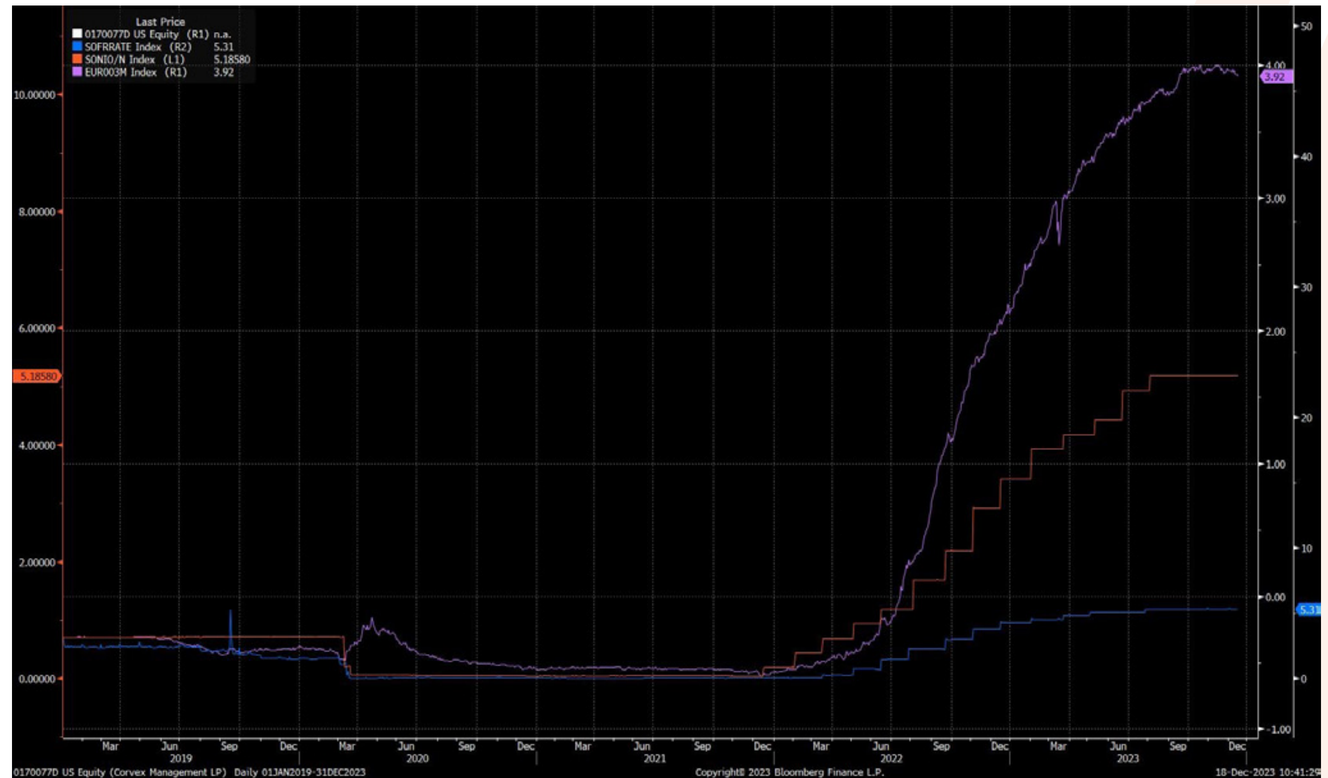

Fig 1: SONIA/SOFR/3 month EURIBOR movements (Bloomberg)

Will the more positive rate outlook be enough to stimulate demand and therefore increased lending activity in 2024? The **LMA's year-end members survey** suggests that lenders are optimistic that demand will pick up and volumes will increase in 2024. However, this appears predominantly based on refinancing requirements (which are higher than last year), and a modest increase in demand for term debt. It is not clear based on external indicators that interest rates will move sufficiently swiftly to stimulate opportunistic refinancings in the near term.

Borrowers will also be mindful of the range of elections in the UK, the US and the EU currently on the cards for H2 2024, and how those might impact market conditions. Electoral uncertainty typically dampens activity levels, but lack of demand can also create opportunities for those in a good position to tap the market.

Based on past cycles, it might be anticipated that some borrowers will reap the benefits sooner than others. After a thin period of activity, a volatile backdrop does not prevent lenders competing on price for the right deals. This typically translates to immediate pricing benefits at the upper end of the investment grade market and for the most attractive

Fig 2: GBP SONIA swap rates (Bloomberg)

private equity deals, with borrowers lower down the credit spectrum or transactions in more vulnerable sectors finding conditions more challenging for a longer period. Margin movements may therefore be sector-specific and in some cases, borrower-specific.

Most forecasts appear to suggest that inflation will stabilise at more normal levels during 2025, meaning that key benchmarks may not reduce significantly until 2025. In addition, potentially negative headwinds, including political uncertainty and potentially impending regulatory changes (in the form of Basel 3.1), are putting pressure on lenders' operational costs. A combination of these factors may serve to support higher pricing for a period extending into 2025 at least. Any reduction when it comes, is, of course, in comparison to post-COVID period interest rates. There is no suggestion that pricing will return to pre-pandemic lows in the foreseeable future.

SUSTAINABILITY-LINKED LOANS (SLLS)

Tightening terms

SLL terms have been under the spotlight in 2023, with the FCA and lenders keen to ensure they provide necessary levels of anti-greenwashing protection to lenders and investors. Whether the credentials of a particular loan are sufficient to apply the SLL label is predominantly governed by voluntary recommended guidelines, the Sustainability-Linked Loan Principles (**SLLP**) published by the LMA and the other loan trade associations. The SLLP and related guidance material were comprehensively reviewed in 2023, the updates placing particular emphasis on the adoption of credible and ambitious KPIs, robust reporting processes and a firm requirement for the external verification of annual sustainability performance targets (**SPTs**).

Many of these requirements are reflected in the LMA's Draft Provisions for Sustainability-Linked Loans (the **LMA Draft Provisions**), published in May 2023 and already quite widely used as a reference point for drafting. Following the publication of the LMA Draft Provisions, contractual protections sought by lenders in SLLs with a view to protecting against greenwashing - for example, ESG amendment and declassification provisions - have become more widespread and detailed.

Treasurers looking to refinance working capital lines in 2024 will need to consider carefully whether they wish to use the SLL structure and whether their ESG strategy and data is sufficiently developed to meet the market's requirements. Early adopters of the SLL structure needing to refinance are likely to find that the terms of a 2019/2020 SLL will require some adjustment to meet 2024 expectations. Treasurers are referred to the **ACT Guide to Sustainability-Linked Loan Terms** for guidance on the SLLP, the LMA Draft Provisions and how they might be viewed from the borrower's perspective.

Will the SLL market return to growth?

During the first half of 2023, global sustainable finance issuance (loans and bonds) totalled $717bn, an improvement on the second half of 2022. However, most of this recovery was attributable to green bond issuance. Sustainability-linked products (which comprise the bulk of ESG-labelled loans) performed less well. Overall, during 2023 volumes of SLLs and bonds (SLBs) struggled to reach even 2022 levels.

It is generally anticipated that the SLL market will return to growth this year, not least due to a general increase in lending activity. The sustainable finance targets which most of the larger financial institutions have now set for themselves suggest that debate about whether the loan should be sustainability-linked will continue to take place in virtually every refinancing and new financing. However, increasing scrutiny on the financial sector's use of sustainability labelling coupled with limited price incentives means some borrowers may continue to question the value of taking on the additional obligations involved in an SLL. Margin discounts are typically minimal (and have become increasingly so as borrowing costs have shifted).

The continuing paucity of the economic incentives attached to SLLs is a factor that may lead some borrowers to take the view that their commitment to sustainability is adequately demonstrated by wider corporate sustainability strategies and disclosures, and that the addition of an SLL is not worth the additional workload. Whether a reassessment of the incentive structure (in particular in the leveraged and other sectors of the loan market where relationship pricing is less prevalent) might tip the balance and facilitate more widespread take-up of SLLs is a question we anticipate many borrowers will be asking during 2024. This is a conversation we believe borrowers should have with their relationship banks. Regulatory and stakeholder pressure to increase ESG-labelled lending volumes could prompt lenders to address borrower-specific challenges, on the basis of borrower acceptance of the standards being imposed to protect the integrity of the market (fuelled further by the FCA's impending anti-greenwashing rule, discussed below) and in recognition of the key role given to sustainable finance by policy-makers in advancing the wider sustainability agenda.

The FCA's anti-greenwashing rule

While SLLs are not formally regulated at a product level, from 31 May 2024 all FCA-regulated firms will become subject to a new anti-greenwashing rule, which applies to all their products and services. This anti-greenwashing rule requires FCA-authorised firms to ensure that any reference they make to the sustainability characteristics of their financial products and services are consistent with the sustainability characteristics of the product or service and are fair, clear and not misleading.

The application of an ESG label (such as SLL) to a financing product would seem to be sufficient to engage this rule, given the labelling feeds into the lender's categorisation of its loan book and related reporting to its regulator and the public. Treasurers may therefore find it helpful to have an awareness of the FCA's approach to greenwashing to provide context for lenders' requests and approach to negotiations.

In the context of SLLs and other sustainable lending products, the proposed FCA Guidance on the application of this rule (currently still in consultation) makes clear that the product must do what its label suggests. For SLLs, this most obviously means alignment with the SLLP and KPIs and SPTs based on data that is regularly updated, reported on and capable of being substantiated.

The rule and related guidance will therefore reinforce various themes that are already apparent in SLL discussions: a focus on benchmarking, the need for science-based targets, requirements for external confirmation of the product's alignment with the SLLP and an overall emphasis on transparency (in the form of public disclosures). However, certain aspects of the proposed Guidance may have wider implications for SLLs.

For example, the Guidance emphasises that sustainability claims should consider the full life cycle of the product or service. For SLLs with longer tenors, this may mean setting SPTs that reach some way into the future, rather than leaving them to be agreed at the appropriate time, which has been the case in some existing SLLs. If future targets are included and somewhat uncertain, borrowers will need to ensure that the SLL includes appropriate rights to adjust and revisit KPIs and SPTs as science, regulation and the business evolves.

The Guidance also states that sustainability claims should not omit or hide important information. This idea that sustainability claims are "complete", or in other words, do not cherry-pick positive sustainability indicators while ignoring less positive indicators, is clearly important in terms of regulatory disclosures to investors and other key stakeholders. It is suggested that this should not be interpreted as requiring a change in practice in relation to SLLs. SLLs and other sustainable finance products are designed to amplify, not represent a borrower's ESG strategy and credentials. It is not a requirement that the SLL includes KPIs reflecting the entirety of the borrower's ESG goals; the requirement is rather that the agreed KPIs are the material factors, when considered in context. It is hoped that in this respect the Guidance is applied in line with the SLLP, rather than more expansively, which would risk undercutting the role of SLLs as a transition tool.

AMENDMENTS TO IAS 1: NON-CURRENT LIABILITIES WITH COVENANTS

Borrowers will need to bear in mind how covenant packages in lending arrangements will be reflected in or impact their financial statements for accounting periods starting on or after 1 January 2024 (see **IFRS on Non-current Liabilities with Covenants, Amendments to IAS 1**).

These amendments make certain changes to the criteria for the classification of a loan as a current or non-current liability, which depends on the entity's compliance with covenant tests on or before the accounting date. Borrowers facing covenant challenges will need to familiarise themselves with this adjusted criteria.

Of broader relevance is a new requirement introduced in adjusted IAS 1 (at IAS1.76ZA) to disclose information about covenants to which non-current liabilities are subject and which are tested *after* the balance sheet date, so users of the accounts can understand the risk that those liabilities could become payable within 12 months of the reporting date. This means that all borrowers with loans subject to covenants that are applicable within 12 months of the accounting date will need to outline those in disclosures to their accounts. The reference to covenants means all covenants, not just financial covenants.

The required disclosures include the nature of the covenants; when the entity is required to comply with them; the carrying amount of related liabilities; and the facts and circumstances, if any, that indicate that the entity may have difficulties complying with the covenants – for example, the entity having acted during or after the reporting period to avoid or mitigate a potential breach. IAS1.76ZA states that *"such facts and circumstances could also include the fact that the entity would not have complied with the covenants if they were to be assessed for compliance based on the entity's circumstances at the end of the reporting period"*.

It is not yet clear how detailed these disclosures might need to be or how the different audit firms will approach them. In particular, it is not clear whether the words quoted above would have the effect of bringing forward future covenant tests, requiring them to be notionally tested at the end of the accounting period by reference to then-existing facts and circumstances, even if not contractually due to be tested until a later date. This may not be a material consideration where the future covenant tests are the same as those applicable at the accounting date. However, the same may not be true for entities which are subject to variable covenant tests; for example, financial covenants that tighten over the life of the loan.

OTHER DOCUMENTATION ISSUES

As regards documentation issues to anticipate, financial covenants are likely to remain a key area of focus. It is good practice to re-assess financial covenant terms on every refinancing, to ensure they remain fit for purpose and that headroom remains sufficient in line with forecasts. While the outlook for funding costs generally might be more positive than has been the case, some borrowers are finding that interest cover ratios require particular attention.

An interest cover ratio (**ICR**) of some kind is common is many types of facility agreement. Most ICRs compare the borrower group's operating profit (often EBITDA) to its interest obligations or "Finance Charges" during the relevant period (normally a 12 month period), putting a minimum floor on the ratio. For example, an ICR might be expressed as a requirement that the ratio of EBITDA: Finance Charges must not be less than 3:1. This ratio, as for other financial maintenance covenants in loans, is tested half yearly on a backwards looking basis in most investment grade loans, with quarterly testing applicable to borrowers moving towards crossover territory and beyond.

In light of potentially higher funding costs (in some cases coupled with greater debt utilisation requirements), we are aware that some borrowers have had to re-set ICR levels more recently. Note that if interest rate hedging is in place, the "Finance Charges" side of the ICR is (or should be) adjusted to take into account the hedging (i.e. the Finance Charges number is adjusted downwards for amounts payable to the borrower under the interest rate hedging and adjusted upwards if the hedging moves the other way). Where applicable, the concern in terms of the ICR may be focussed predominantly on movements (if any) in the margin.

Other topics likely to crop up in documentation discussions include risks relating to defined benefit pension schemes and the topic of sanctions. Each of these are discussed in the Hot Topics chapter of our **ACT Borrower's Guide**.

More technical documentation points that may be relevant include the following:

- Further adjustments to benchmark provisions relating to non-LIBOR currencies, including, for EURIBOR-referencing loans, €STR-based fallbacks (outlined further in our briefing on **Recent IBOR Developments**).
- Requests from Lenders to widen further the scope of increased costs indemnities to include all elements of Basel 3 and related implementing measures, in light of developments relating to Basel 3.1 (the final elements of Basel 3, which will not be implemented in the UK until 2025). Borrowers will need to focus on ensuring that such adjustments are appropriately framed and subject to exceptions (our **ACT Borrower's Guide** includes a number of suggestions).
- The FCA is in the advanced stages of **consulting on major changes** to the UK Listing regime, which include proposals to simplify the rules governing significant transactions. These tests (for example the test for Class 1 transactions) are sometimes used as reference points for exceptions in loan covenants restricting acquisitions and (less commonly), disposals. Borrowers whose loan documentation includes such provisions will need to discuss with their advisers whether, and if so how best, to reframe and future-proof the drafting in light of the proposed changes.

FURTHER INFORMATION

For more information about the issues highlighted in this briefing, please contact your usual adviser at Slaughter and May or any of the lawyers listed below.

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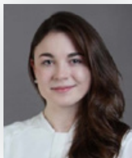

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