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Credit protection in investment grade syndicated credit facilities – recent trends

In the immediate aftermath of the onset of the global financial crisis (**GFC**) commentators were in general agreement that providers of financing in many markets had lowered their credit standards to unacceptable levels and that this state of affairs had to change.

Of course, this sentiment was most prevalent in those markets which were directly the cause of/affected by the GFC (e.g. the markets for mortgage-backed securities and the leveraged finance markets). However, all credit markets were, to a greater or lesser extent, affected by this general desire to tighten credit standards (a trend which should be exacerbated by the additional capital costs of providing credit which are a consequence of the changes in regulation which have followed the GFC).

One area which one would expect to be affected by this call for tightened credit standards is the corporate syndicated loans market (often referred to as the "investment grade" market – although some of the borrowers may be unrated or rated just below investment grade).

Clifford Chance has carried out a comparative analysis of a significant proportion of the corporate syndicated loans completed in the European markets over the last 3 years and in this article we set out some of the key findings.

Types of credit protection

Of course, there are a number of ways in which loan documentation can assist lenders with credit protection, but for this purpose the main categories of provision which we have analysed are ones giving protection against:

- **Diminution in credit quality:** these are provisions – such as financial covenants and material adverse change (**MAC**) clauses – which trigger acceleration rights or which enable lenders to refuse to lend further if the credit quality of the borrower/borrower's group becomes significantly worse over the life of the facility.
- **Significant changes in business shape:** these are provisions – such as restrictions on acquisitions or disposals – which restrict the ability of the borrower/borrower's group to make significant changes to their business (which may increase or change the riskiness of that business) without lender approval.
- **Subordination of lenders' claims:** these are provisions – such as security (rarely seen in the investment grade market), guarantees from operating companies (**Upstream Guarantees**), negative pledges and restrictions on priority indebtedness – which seek to ensure either that the claims of the lenders have priority over those of other creditors or, at least, are not subordinated to them.

Rating levels make a difference

Unsurprisingly, the higher rated a corporate borrower is the looser the provisions aimed at providing credit protection in its credit documentation tend to be. In particular:

- Borrowers in the **AAA** → **AA-** bracket (we use the Standard & Poor's ratings throughout this article) rarely borrow in the syndicated markets, but when they do they can insist upon minimal credit protections.

  Typically, they will not be required to agree to financial covenants or MAC clauses which are aimed at protecting lenders against a diminution in credit quality. They will probably not have to accept limitations on their ability to carry out significant business transactions without lender approval (e.g. restrictions on acquisitions, disposals, mergers and additional indebtedness). Normally, they will be able to borrow at holding company level without giving their lenders Upstream Guarantees from operating/asset owning companies in their group.

  Sometimes they will not even be required to give a meaningful negative pledge.

  So these borrowers are essentially requiring documentation which pretty much replicates what they would expect if they were raising finance under a bond issue. Banks seem prepared to accept this on the basis that these borrowers are very high quality credits whose credit-worthiness is unlikely to diminish significantly over the period of a syndicated loan (typically 5 years, although 7 year deals have been seen) and who are usually willing to provide some ancillary business to their core banking group.

  However, even for these very strong borrowers there is a risk that their credit-worthiness may deteriorate over

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time and lenders under a syndicated loan will normally not have the comfort of documentary protection against such risks. Indeed, in some circumstances, lenders have fewer protections than bondholders, since bondholders can at least sell their bonds into the market freely if they have become unhappy at their credit quality, whereas lenders to such strong credits are often required to agree that they cannot transfer the loan without the agreement of the borrower (albeit that there are methods – such as credit derivatives and sub-participations by which the credit risk can be "transferred").

- **A+** → **A-** rated borrowers are very often treated in a similar way to the **AAA** → **AA+** borrowers in that they will rarely have to agree to financial covenants or MAC clauses. However, our analysis shows that they are more likely to be required to agree to restrictions on disposals and mergers (albeit that the terms of such restrictions can sometimes be quite loose). Restrictions on acquisitions and additional indebtedness are less usual. These borrowers are unlikely to have to provide Upstream Guarantees, but they will grant negative pledges and will sometimes agree to give their lenders a "priority indebtedness" clause (which essentially restricts the ability of the borrower to give other creditors a more advantageous lending/guarantee structure than those lenders have). In the absence of Upstream Guarantees (or security), these priority indebtedness clauses are worthwhile protections for lenders.

- For borrowers which are just within the investment grade category (**BBB+** → **BBB-**) our analysis shows that there are clearly more credit protections included in loan documentation. However, there are significant variations in the protections which lenders are able to achieve in negotiations. For example, some borrowers in this category accept financial covenants and MAC clauses, while others have successfully resisted them. Similarly, while most of these borrowers agree to some level of restriction against changes in business shape (e.g. restrictions on disposals), the level of protection is by no means uniform and certain restrictions (e.g. restrictions on acquisitions) remain controversial.

  Borrowers in this category may agree to provide Upstream Guarantees but this is very much a question for individual negotiation. However, it is certainly the case that if no Upstream Guarantees are given then a priority indebtedness protection will need to be considered.

- Our analysis (unsurprisingly) confirms that borrowers which are just below investment grade (**BB+** → **BB-**) have to agree to more wide ranging credit protection provisions. They will have to agree to financial covenants and MAC clauses; they will almost certainly have to sign up to a full suite of restrictions on change in business shape; and they are more likely to be required to provide Upstream Guarantees (albeit that this is not always the case).

  However, one can see that there are some borrowers in this category who have persuaded their lenders that they are moving towards investment grade quality and, therefore, should be treated more like the **BBB+** → **BBB-** borrowers.

Geography and events make a difference

One trend which is clear from our analysis is that special circumstances can make a difference to how credit protection is looked at in the syndicated loan market.

For example;

- In some regional markets where the local banks have particularly strong relationships with their borrower clients, these clients can often achieve looser terms than one might expect from the rest of the analysis.
- Where a borrower is undertaking a significant, event-driven transaction which requires it to leverage up substantially (albeit perhaps only temporarily) lenders may successfully insist on credit protections which that borrower might ordinarily be able to resist.

Changes since the Global Financial Crisis

So does the analysis show that the increased awareness of credit risk caused by the GFC and the additional costs of capital being introduced by the regulators have caused credit protections in investment grade/corporate syndicated credit transaction to be tightened?

Our sense is that, while there was clearly a period in which such a tightening took place immediately after the onset of the GFC (at which point the availability of credit itself was problematic), in fact the credit protection terms available to high quality borrowers today are no tighter than they were prior to the GFC. Whilst some lenders may be more conscious of credit risk, market pressures have ensured that we have largely returned to pre-GFC credit protection standards. However, it should be stressed that this market was never subject to the same "bubble" effect as some other markets so that a return to pre-GFC standards is not necessarily a cause for concern.

The effect of increased capital requirements on the availability and cost of capital for corporate lending in the future ought to be that credit protection standards will gradually tighten. However, it remains to be seen whether this will actually occur as banks continue to compete fiercely for the loan (and ancillary) business of major corporates.

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