European Leveraged Finance Association

BRIEFINGS

ELFA Open Letter – Notes from the Engagement Roundtables

ELFA published an open letter from our Board (the "Open Letter")[1] addressing critical issues within the European leveraged finance market. Titled "Taking Stock of Market Standards on Disclosure, Process, and Engagement in the European Leveraged Finance Market", the Open Letter outlines the current challenges faced by lenders and the broader market due to insufficient disclosure, rushed processes, and limited engagement.

The Open Letter highlights a series of practices that we believe to be detrimental to the future of the leveraged finance market and notes the work we have done to support strong standards of market practice since our inception, including best practice guidance we have published in many of the areas mentioned. ELFA continues to observe market behaviour and will advocate for high market standards and support a lightly regulated leveraged finance industry concerning the issues discussed in the Open Letter.

The aim of the roundtables was to facilitate discussion of the issues raised and hear perspectives from lenders, banks, law firms and sponsors to work towards a stronger, more efficient, and more resilient leveraged finance market. We provided a Discussion Guide to roundtable participants to facilitate a dialogue on the issues raised in the Open Letter.

Discussion Guide

Addressing compressed timelines and complexity in leveraged loan and high yield bond market documentation

- Rushed processes have the effect of reducing the scope for negotiation.
- The current timelines for reviewing documentation in both the leveraged loan and high yield bond markets are too short, often leaving lenders with insufficient time to analyse and negotiate terms.
- Leveraged loan lenders frequently receive limited or draft documentation, with full documentation provided only a day before commitments are due. This rushed process is particularly evident in repricing transactions, where lenders may have as little as 48 hours to consider their decisions.
- Our best practice guidance states that a minimum of 5 days should be provided to review the long-form SFA and that a redline of the updated Syndication Term Sheet should be provided - what obstacles prevent this from being followed and how can we overcome these?

Discussion Points

Market Dynamics

- The timelines for reviewing documentation are compressed and often leave lenders with insufficient time to analyse and negotiate terms thereby making it difficult to provide longer review times. It is crucial to understand what is truly driving this from the banks and sponsors' end. This change, which can be attributed to the recent market dynamics, has been worsened by the Covid-19 pandemic and global conflicts.
- Leveraged loan lenders often receive limited or draft documentation, with full documentation provided just a day before commitments are due. In repricing transactions, lenders may have as little as 48 hours to consider their decisions.
- Rushed processes reduce the scope for negotiation as they do not allow sufficient time for analysis at a time when lenders are seeing an increase in the disclosure requests that they need to cater to. This increase is largely due to deterioration in communication, the rise in the events of default and recent cases of corporate actions causing lender surprise.
- Previously, syndications took three weeks; two weeks for orders subject to reviewing the necessary documents and one week for the loan documents to be reviewed. The market has evolved to require quicker timelines to avoid market risk. This creates challenges for lenders in analysing and negotiating terms.

[1] Open Letter from the Board of the European Leveraged Finance Association

- While the market has become more efficient in analysing covenants by employing experienced analysts having an increased number of resources at their disposal to review documents, rushed timelines in new deals do not consider the capacity constraints from the buyside.

Issues caused by delayed documentation

- There has been a deterioration in practice as lenders often do not have the SFA until the day before commitments are due. Thus the current timelines for reviewing documentation are often insufficient for proper analysis.
- While compressed timelines may be more acceptable in cases such as refinancing, in new money transactions this hampers the buyside's ability to thoroughly analyse the documents. Analysts take time to analyse a first-time deal and often need to present their findings to a committee, which is often exacerbated by the lack of covenant-related disclosures early on.
- It was noted that banks do not get many comments or input during the pre-marketing phase.
- Sponsors are often reluctant to make edits to the documents early unless necessary, this means that many changes are not reflected in the black line version.
- From a long-term perspective, if analysts do not thoroughly understand the credit, lenders are more likely to exit at the first sign of borrower distress. This often creates difficulties for the underwriters.

Reasons behind delayed documentation

- It was highlighted that this compression in the timeline may be for issuer convenience. Issuers would prefer to negotiate the documents during premarketing with a smaller group of investors who drive the deal. Moreover, parties are more cognisant of the fact that these instruments come with pricing windows and there is now an increased pre-marketing of the deal. As this process has evolved rapidly, there is a greater focus on hedging market risk.
- Another participant emphasised that the timelines are not compressed for nefarious reasons. Loan documents are being posted later simply because banks and their advisers may not be organised and actively prioritising them. Bank arrangers are not focused on documentation timelines, leading to rushed processes. It also needs to be acknowledged that there is an urgency to complete the revised SFA which the lawyers might be prioritising, and thus marketing may be unable to service this.
- While the rationale for sped-up processes is unclear, it creates negative publicity and investor concerns. Negative headlines about poor documentation can lead to investor concerns about market protection and covenant quality.

Best Practice Guidelines

- ELFA's best practice [2] recommends a maximum period of 5 business days for the review of documentation. Participants recommended amending it to 2-3 business days as the timeline for the long form SFA.
- It was pointed out that 5 days may not be a feasible length of time and putting a timeline on syndication may be ineffective.
  Participants highlighted that the market practice needs to differentiate between amendments and new money transactions.
- The US loan market suggests that timelines should be adapted based on the quality of the issuer rather than adhering to a fixed period, allowing for more flexibility and better alignment with issuer capabilities.
- Participants further highlighted that they are afraid that some of the measures would cause the market to be perceived as difficult to deal with and could potentially alienate issuers.
- There is a need to explore more ways to provide more review time without excessively elongating the process.

Suggestions to improve timelines

- There was a suggestion that underwriters could provide preliminary information from the SFA in stages as soon as it becomes available. This might, however, cause greater confusion in communication of the relevant information.
- Participant underwriters indicated that providing information early would be fine for them. While banks can make recommendations and try to get information out within 24-48 hrs, ultimately the timing and release are based on the sponsor's judgement.
- It was agreed that discussions with sponsors would be required, as they are the parties responsible for timelines and instructing the lawyers regarding the process.
- ELFA plans additional engagement with sponsors.

[2] ELFA Best Pratice Guidance to Syndication Process

Discussion Guide

Insufficient covenant information

- There is a lack of reporting on covenant-related information, which creates potential surprises due to unexpected borrower behaviour. This lack of transparency is detrimental to all market participants.
- The Open Letter references the International Organization of Securities Commissions (IOSCO) Good Practices on Leveraged Loans and CLOs, which recommend clear disclosure of material covenants and associated terms.
- Our New Deal Disclosure Questionnaire requests information on day one Restricted Payments and Debt capacity, and ratio calculations. What obstacles prevent this information from being provided, and how can we overcome these?

Discussion Points

Covenant Complexity and Transparency

- The complexity of documents combined with the reluctance to calculate and disclose numbers contribute to the lack of transparency. Standardising documents and providing tangible numbers would be beneficial in addressing this.
- While covenant-related information has become more complex, it has also become less transparent. This has led to an increase in the potential for surprises and increased risk aversion.
- Participants suggested that providing aggregate amounts and clear breakdowns of covenant information would make the process more efficient and reduce risk aversion since it is much easier to comment on documents if you know the aggregate capacity.
- Lenders often find it difficult to obtain reasonable estimates of the basket amounts, as it is intended by lawyers to ensure maximum flexibility for the borrower. However, it was pointed out that lawyers generally do not calculate baskets or provide the basket amounts, and the complexity of provisions make the baskets difficult to understand. While sharing these figures widely would increase standardisation, it is important to note that loans often appeal to borrowers because they are more private than other asset classes such as bonds.
- Sponsors are unlikely to agree to provide detailed covenant information unless there is consistent buy-side demand.
- While borrowers track their covenant capacities, they are often reluctant to provide public information upfront. This leads to guesswork on the part of lenders which often leads to inflated numbers, subsequently resulting in caveats around the same. The key to this could be being less ambitious with requests and starting with key baskets or terms, which could be more effective.
- Both lenders and International Organization of Securities Commissions (IOSCO) have advocated for increased information regarding covenants.

Reasons for Decreased Transparency and Challenges to Information Dissemination

- Participants pointed out that they often have press leaks regarding deals that have not launched, often with inaccurate information which has led to trust issues. These underlying trust issues are one of the key reasons for withholding covenant-related information.
- It was highlighted that information is often shared to aid the process of credit analysis; however, banks are exasperated by the violations and the lack of strict adherence to NDAs.
- Legal counsel and investment bankers often advise against a slide in the roadshow deck with disclosures to protect issuer interests. As covenant disclosure can become a liability issue, it is unlikely to be disclosed during the roadshow as banks who drive this would prefer to focus on business aspects and would push the conversation around covenants offline. However, regardless of disclosure by issuers, this information is readily available with third-party providers who estimate it.
- It was acknowledged that it would be difficult for sponsors to quote numbers as it could be held against them. Furthermore, the problem with allocation and reallocation is that it is not straightforward and is easy to miscalculate. Buy-side participants further pointed out that while bankers do not answer questions on covenants in groups or one on one during roadshows, the process of waiting 24 hours to get a response in the event that a response is given, is not enough time to price the risk. There is far too much buried in the language and thus sponsors should aim to make the covenant packages clearer and more easily discernible.
- While sponsors stated that they do not have a problem with disclosure, they often find that the more time they give, the more information is given to financial press. They opined that it is unfair to ask for a situational-based calculation on the roadshow. However, the delay in getting back is unacceptable and should not exist.

Suggestions to Improve Covenants

- Having an estimate from a good faith perspective with as many caveats as possible which is shared annually would be an immensely helpful clarification on the inputs the analysts need to know.
- It was suggested that continuous disclosure could also be considered since lenders would like to know the capacities and their usage periodically and over time.
- The impediments from the legal side are that they follow the sponsor's instructions and are mindful of leaks and over-disclosing as they prefer to carefully control the flow of disclosure and are collectively working to improve it. It was suggested that sponsors could give transactions where the covenants baskets are used and then the lenders could calculate baskets themselves.
- There was a suggestion that lenders could engage with covenant providers to see if they can provide the covenant related information earlier.
- Participants pointed out that following best practices in these scenarios may be difficult while highlighting that the current guidelines are broad and elaborate. It was noted that the sponsors themselves are best placed to change market practice in this case.
- ELFA plans additional engagement with sponsors.

Discussion Guide

Increasing Restrictions on Transferability

- Overly restrictive transferability conditions are hampering liquidity and negatively impacting the market's health. ELFA has been engaging with private equity sponsors to voice these concerns and is considering publishing best practice guidance on transferability.
- Documentation and operational recommendations that we made to private equity sponsors include, among others, reviewing minimum transfer amounts, waiving transfer fees in certain circumstances, reducing the deemed consent period, and all restrictions falling away in the event of default.
- We also recommended that the whitelist be circulated annually and capping the number of institutions that can be removed from the whitelist, replacing those institutions on the whitelist, and opening the secondary market much sooner post-primary allocation.
- A number of the recommendations we proposed to private equity sponsors have been made in the International Organization of Securities Commissions (IOSCO) Good Practices on Leveraged Loans and CLOs.

Discussion Points

Restrictive Transfer Provisions

- Transfer restrictions have become more constrictive, thus hampering liquidity and detrimentally impacting the market's health. Participants pointed out that for the leveraged loan market to be viewed as a mature market, this and the issue of liquidity need to be improved. They also noted the increase in deals with off-market deemed consent periods and sponsor consent.
- Collective buy-side demand is needed to push for better provisions.
- Sponsors and their lawyers often push for tighter document to maintain control over loan transactions, leading to constant negotiations and reduced flexibility for lenders.
- Improving transferability provisions is crucial to promote market liquidity and making the loan market more attractive.

Incentives and Reasons for Restrictive Provisions

- The decisions that are meant to support the longevity of the market may not be equitable as the makers of the deal often have other incentives.
- It was acknowledged that some of the restrictions are helpful for the issuer or the sponsor as it increases their ability to transfer risk.
- Participants pointed out that minimum requirements are driven by the agents and are significant for them. They speculated that agents may charge more for transfers.
- Whitelists often pick up stringent restrictions even in syndication, such as 100% consent, which received a lot of pushback in the market. Often such restrictions tend to come from real-world experience and not malice. If the market becomes bigger, it is an area where mechanical restriction may not always help.

Suggestions for Addressing Restrictive Provisions

- The buy-side should demand better transferability provisions to drive change. However, the buy-side has insufficient time to read the documents and thus are unable to push back to the extent they may wish.
- It was pointed out that jurisdiction specific regulatory concerns on consorted efforts further hinder the borrowers from pushing back collectively.
- There is a need for investor bodies like ELFA to step in due to the presence of regulations. It was highlighted that there are examples of US loan market deals that have driven practitioners to change.
- Engaging with the heads of business of private equity sponsors outside of the deal context could be more helpful while urging them to take a more holistic view.
- ELFA plans to engage on this topic further with private equity sponsors.
- Engaging with providers on good governance, educating them on it and how these practices influence it, could help ELFA in creating awareness and making it more relevant to issuers.

Discussion Guide

Password-protected websites for financial information

- We have warned against the use of password-protected websites since our inception, as their use runs counter to a well-functioning public securities market.
- Recently it has come to our attention that the use of password-protected disclosure is impeding the ability of ESG rating agencies to conduct ESG analyses of leveraged finance issuers.
- Why does the use of password-protected disclosure persist, and how can we move away from this practice?

Discussion Points

Password Protection and the Reasons for Decreased Transparency

- Participants mentioned that they are unsure why the sponsors insist on restrictive practices as lenders could sign an NDA and protect any sponsor concerns.
- It was further pointed out that these barrier do not prevent the press from getting access, which only further antagonises the lenders.
- Practices such as aggressive whitelisting as seen in a recent example of a bond-only issuer, decrease the pool of liquidity for the existing bondholders.
- Furthermore, for companies to declare themselves as public, they should not have such information behind password protection. It was observed that this is often conducted by private companies that are not listed since they prefer to have control over who is able to view their information as NDA violations are becoming more commonplace.
- ELFA's Disclosure & Transparency Committee has discussed the issue of password protection at length; this practice still exists as there is information on company websites that they do not want their competitors to use.
- It was agreed that it is important that this information be easily accessible from a long-term perspective.

Challenges to and Suggestions for Reducing the number of Password-Protected Websites

- Participants discussed that they were unsure why the problem persisted and how to deal with it, as waiting 24-48 hours to get access with a challenging sign-up process only reduces the instrument's liquidity.
- Additionally, removing password protection increases transparency which means that the quality of the company's analysis increases and enables bonds to be traded better.
- With the increased pressure for transparency and ESG, banks mentioned that they actively recommend against the use of password-protected websites as it leads to lower liquidity and increased volatility. However, some issuers insist on employing it as a means to exclude their competitors from accessing information, it is largely a decision directed by management teams.

Suggestion for Reducing the number of Password-Protected Websites

ELFA's D&T Committee has suggested that we can move away from this practice by engaging with ESG providers and MSCI to create a framework for good governance.

Next Steps

- ELFA will continue to engage on these issues with sponsors – specifically heads of businesses and relevant stakeholders.
- ELFA will continue to collaborate with its Partners and its Initiative Committees to continue to educate, gather feedback and work on existing initiatives to further address the issues discussed.
- ELFA will update the discussed best practice guidance based on the suggestions and comments from the discussion.

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