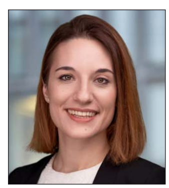
INTRODUCTION

Contributed by: Christine Hohl and Caroline Riesco, **Loyens & Loeff**

Loyens & Loeff is a leading continental European law and tax firm with over 1,000 advisers, and is the logical choice for companies doing business in or from the Netherlands, Belgium, Luxembourg and Switzerland, its home markets. The banking environment is constantly evolving. Financing solutions are multiplying and legal implications related to financial products are becoming more complex. Due to the ever-changing economic, political, environmental and regulatory worlds, financial markets will continue to be a challenge in the years ahead. Loyens & Loeff keeps track of the developments and helps its clients to navigate the increasingly complex debt and financial markets. It also goes a step further – guiding its clients in identifying opportunities and innovative ways to access the funding most suitable for them, whilst also managing risk. It is the firm's job to stay ahead of these changes for its clients, allowing them to stay focused on their core business.

Contributing Editors

Christine Hohl is a partner and a member of the banking and finance department in the Zurich office of Loyens & Loeff. She focuses on financing transactions, including acquisition financing, asset financing, project financing, real estate financing as well as debt issuances and securitisations. Christine has 15 years' experience in international financing transactions, both LMA- and LSTA-style, as well as domestic financings, restructurings and capital markets transactions, in the UK and Switzerland. She is dual UK- and Swiss-qualified.



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Navigating the Dynamics of Global Debt Finance Markets

This Practice Guide will focus on the key topics in Debt Finance in 2023 and 2024. In this series of articles, legal practitioners from various jurisdictions will analyse both the law and practice, as well as the trends and developments, in the debt finance market in their home country.

Market Overview

The year 2023 proved challenging for debt finance markets everywhere. Confronted with rapidly rising benchmark interest rates, bank collapses, persistent inflation, an energy crisis, prolonged supply chain issues and geopolitical shocks resulting from global conflicts, market actors kept exhibiting a wait-and-see approach. The M&A market also slowed significantly as buyers' and sellers' views diverged on valuations and the cost of capital increased for buyers.

Transition to a new phase of the economic cycle

Globally, interest rates stayed high, contributing to market volatility as policymakers aimed to manage both inflationary pressures and the risk of recession. This resulted in sponsors and borrowers encountering elevated debt pricing which limited opportunities for opportunistic financings. Towards the end of 2023, some progress could be observed in primary market pricing, although secondary markets continued to be impacted.

As the effects of policy tightening start to alleviate inflationary worries and associated issues, the markets appear to be transitioning into a new phase of the economic cycle in 2024.

Volume and typology of transactions

While the debt finance market maintained a relatively subdued stance compared to historical trends, there was notable improvement from the lows of 2022, albeit from a modest starting point. However, it should be noted that a majority of transactions were implemented to stabilise capital structures rather than for new acquisitions or investments. Notably, the market witnessed several transactions geared towards extending maturities and ensuring continued compliance with covenants, including term loan B (TLB) amend-and-extend deals, add-ons, covenant resets and other refinancings.

Key events in the banking sector

In March 2023, global uncertainty affected the banking sector, starting with the collapse of Silicon Valley Bank. Regulators stepped in quickly to manage the contagion from the second-biggest bank failure in US history, while the UK government arranged for HSBC to acquire the bank's UK arm.

A few days later, Credit Suisse was faced with a downward spiral in its share price. This prompted action from Swiss authorities and culminated in the merger of two globally significant banks, UBS Group and Credit Suisse Group.

Structural Trends in Debt Finance

This section highlights international trends as well as trends more specific to the European debt finance markets.

International trends

As conventional funding avenues faced increased limitations across various jurisdictions, borrowers increasingly sought out alternative sources of funding, notably private capital, turning their backs to the traditionally relied-upon widely syndicated loan and underwritten high-yield markets. Although the product mix within traditional finance options, such as high-yield and TLB borrowings, largely mirrored past patterns, term loan A (TLA) and asset-backed financings also resurfaced as sources of capital. Whereas both TLAs and TLBs constitute forms of senior secured debt, TLBs tend to have longer maturities and floating interest rates, while TLAs have shorter maturities and fixed interest rates. These financing options provide flexibility for companies seeking capital in different scenarios.

Loan extensions and snooze drag clauses

So-called “snooze drag” clauses are becoming very popular among European borrowers, in particular, in the leverage finance space. Here, “snooze drag” workarounds are used in loan documentation in order to extend maturities more easily amid higher interest rates and upcoming maturity walls.

Typically, when amending a loan to extend its maturity, the approval of all participating lenders is required.

However, managers of collateralised loan obligations (CLOs) – which constitute a significant portion of the leveraged loan market – often face difficulties accepting maturity extensions. This is due to the applicability of specific tests, such as the weighted average life (WAL) test. As CLOs approach the end of their lifecycle, satisfying such tests becomes more difficult. A snooze drag clause helps overcoming this difficulty by allowing all lenders, including CLOs, to “snooze” their vote of approval. In other words, they do not need to actively respond to an extension request within the specified time period. By interpreting their silence as a tacit agreement, the borrower effectively “drags” them into the extended loan.

According to S&P research, “snooze drag” clauses were used in eight out of the ten largest European CLO transactions in 2023.

The European move towards sustainable finance and net zero

The move towards sustainable finance and the pursuit of net-zero emission targets were prominent themes in 2023, particularly in Europe. This transition underscores a growing recognition of the financial sector’s responsibility in tackling climate change and advancing sustainability goals.

Throughout 2023, market participants remained heavily focused on green and sustainability-linked financing. It should be noted that more than half of European leveraged loans now incorporate ESG features, indicating a trend towards standardisation in such provisions. Corporations are actively assessing the cost-effectiveness of adopting new ESG frameworks, weighing factors such as increased reporting complexity and evolving regulatory standards against the perceived benefits in terms of reputation, pricing, and other advantages observed thus far.

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Meanwhile in the US, a backlash against ESG and its growing influence can be felt in numerous Republican states.

Texas and Utah are leading the challenge of 26 states against a rule issued by the Biden administration in November 2023 that allows for socially conscious investing (ie, considering ESG factors alongside traditional financial factors) in employee retirement plans. The challenge, which argues that the ESG investing rule exceeds the limits of the law governing retirement plans, has found its way to a US appeals court, but the latter has now been asked to hold off its decision until the eagerly anticipated ruling of the Supreme Court on the regulatory power of federal agencies which is expected in June this year and which could have a significant impact on the fate of the ESG investing rule.

Selective Regulatory Developments

The EU and, to a somewhat lesser extent, the US, saw a number of noteworthy regulatory developments in ESG and carbon regulation. Progress was also made in strengthening the financial sector and combating money laundering.

ESG and carbon regulation

The EU Carbon Border Adjustment Mechanism (CBAM), effective as of 17 May 2023, targets carbon-intensive imports into the EU from countries outside of the EEA and Switzerland. The CBAM is intended to complement the EU Emissions Trading System and to put EU and non-EU businesses on an equal footing, ensuring that production of carbon-intensive goods does not shift from the EU to third countries to take advantage of less stringent climate policies. It is also designed to encourage other countries in the world to join the EU's climate efforts by introducing their own measures to tax or price emissions. During the transitional phase (which runs from 1 October 2023 to 31 December 2025), only reporting obligations apply. Carbon pricing (ie, the obligation to buy emissions certificates) will start applying from 1 January 2026.

Also in connection with the transition to a low carbon economy, the EU Green Bond Regulation was adopted on 23 October 2023. The regulation lays down uniform requirements for issuers that wish to use the designation "European green bond" or "EuGB". It aims to set a gold standard for green bonds, thereby opening up new opportunities for issuers and investors and helping to tackle greenwashing.

On 14 December 2023, a provisional agreement was reached on the EU Corporate Sustainability Due Diligence Directive (CSDDD). The CSDDD aims to enhance the protection of the environment and human rights in the EU and globally. The directive will set out obligations for large companies to mitigate the actual and potential adverse impact on human rights and the environment of their own operations, the operations of their subsidiaries, as well as their business partners.

Meanwhile, on 6 March 2024, the US Securities and Exchange Commission (SEC) adopted rules to enhance and standardise climate-related disclosures by public companies and in public offerings. These rules aim to respond to investor demand for more consistent, comparable and reliable information about the financial effects of climate-related risks on an issuer's operations and how it manages those risks.

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Increased regulatory compliance and operational requirements in the financial sector

UK and European banks are progressing Basel III reform programmes. The new cash reserve ratio rules will start to apply on 1 January 2025. Implementation of the capital reforms is growing more complex and expensive, with data and technology cited as the top two challenges according to EY research. Cost of regulatory compliance is on the rise, with expenditure estimated to reach GBP7 billion across the UK and European markets. Although challenging, this implementation will be critical to maintaining the global position, competitiveness and economic viability of Europe's banking sector. US regulators have proposed July 2025 for compliance with the new requirements, with a multi-year transition period.

From an operational perspective, the Digital Operational Resilience Act (DORA), an EU regulation that entered into force on 16 January 2023, and will apply as of 17 January 2025, will play an important role in strengthening the information and communication technology security of financial entities such as banks, insurance companies and investment firms. DORA aims to ensure the resilience of the EU financial sector in the event of a severe operational disruption.

An EU Anti-Money Laundering Authority

On 13 December 2023, EU lawmakers reached a provisional agreement to create an EU Anti-Money Laundering Authority (AMLA). The AMLA focuses on supervising entities in the financial sector that are exposed to the highest risk of money laundering (AML) and terrorism financing. Additionally, the AMLA supports financial intelligence units (FIUs) by enhancing their analytical capacity related to illicit financial flows. It aims to make financial intelligence a crucial source for law enforcement agencies.

The AMLA has both direct and indirect supervisory powers over in-scope entities and can impose sanctions and measures to enforce compliance with AML regulations and those aimed at combating the financing of terrorism (CFT). The creation of the AMLA represents a significant transformation in the EU's AML/CFT supervision: it enhances co-operation among FIUs and strengthens the fight against money laundering and terrorist financing.

Key Perspectives for 2024 and Subsequent Years

As policy tightening is starting to ease as inflation stabilises, debt finance markets show positive trends and are expected to improve significantly over the course of 2024 and beyond into 2025 and 2026.

A more active debt finance market

An upcoming wave of refinancings and restructurings is being expected as we are approaching a maturity wall for five-year debt instruments dating back to the 2020/2021 wave of refinancings. Higher interest rates are now the new norm to which market participants have adjusted their expectations. As inflation is stabilising, volatility is reducing and interest rates are expected to come down in the course of this year, a more robust market activity can be anticipated.

The interest rate landscape

US economic growth is expected to remain resilient in 2024, making the US Federal Reserve cautious about rate cuts and about making these cuts too early. On 20 March 2024, it announced that it would maintain its current range of 5.25% to 5.5%, while affirming its forecast of three rate cuts later this year.

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In Europe, the European Central Bank (ECB) is seeing inflation declining – with projected inflation in the Eurozone to average 2.3% in 2024, 2.0% in 2025 and 1.9% in 2026. On 7 March 2024, the ECB announced that it would keep its key interest rates unchanged at 4.50%, 4.75% and 4.00% respectively, with a first rate cute expected in June 2024. The Bank of England said on 21 March 2024 that it would also keep its interest rated unchanged at 5.25% for the fifth time in a row.

A global election year

The US presidential elections in November will potentially have a large impact on US economic policy, regulatory frameworks and investor sentiment. A transition of power from one administration to another could lead to important shifts in fiscal, healthcare and environmental policies, international trade and foreign relations, affecting global trade flows, supply chains and investment behaviour.

Globally, 2024 can be considered as the ultimate election year with national elections in a minimum of 64 countries (as well as on EU level) representing 49% of the world's population. The outcomes of those elections will undoubtedly have significant macroeconomic and geopolitical implications and affect global debt markets in 2024.