Norton Rose Fulbright

The outlook for 2023

What to expect in the syndicated loans market

December 2022

Introduction

The biggest risk factor that is anticipated to affect the syndicated loan market in 2023 is the global economic condition and the resulting market volatility. In this article, we focus on some of the challenges anticipated for the syndicated loans market from such market dislocation. We have also highlighted two loan products that should become more prevalent in 2023 and beyond.

Banking and finance in periods of market volatility

Sudden market dislocations often lead contractual counterparties to attempt to avoid their contractual obligations. Current crises had put particular pressure on the financial markets and banks will be exposed to contract avoidance risks.

COVID-19, Brexit, war and sanctions and the supply shocks they have caused have all led to abrupt changes in markets. In response, counterparties have revived arguments based on vitiating factors such as mistake as well as frustration and force majeure in order to avoid contracts. Some recent examples include: NKD Maritime v Bart Maritime (No. 2) [2022] EWHC 1615 (Comm) (COVID-19 lockdown measures in India not constituting force majeure); Laysun Service Co Limited v Del Monte International GmbH [2022] EWHC 699 (Comm) and MUR Shipping v RTI Ltd [2022] EWCA Civ 1406 (US sanctions on Iran did constitute force majeure, although in some cases this could be overcome by reasonable endeavours); Bank of New York Mellon v Cine- UK [2021] EWHC 1013 (QB) (COVID-19 restrictions in the UK did not frustrate a commercial lease).

Current dislocations include increases in interest rates and inflation, declines in bond values and changes in currency exchange rates. These affect lending and security arrangements entered into by banks.

The recent Revlon litigation in New York has raised fears globally about the liability of agent banks in finance transactions and limitations in dealing with mistaken transactions. In this case, a bank made an erroneous payment in respect of a New York law governed loan transaction and sought to recover it, but the claim was rejected at first instance by the New York District Court. Although the New York Court of Appeals recently overturned this decision and many banks have also now added new erroneous payment provisions, this could still be a source of new litigation. There is uncertainty as to the ambit of recovery for mistake under many different governing laws and in particular the level of knowledge of the payee that will allow a payment to be reversed.

Inflation and higher interest rates are also likely to lead to an increase in corporate distress, restructurings and insolvencies, in turn giving rise to disputes around the enforcement of security and parent/personal guarantees and the discovery of fraudulent activities.

Restructurings and formal insolvencies

In light of the hardening economic environment and following the phase-out in most major economies of the government support that had been provided in response to COVID-19, we expect to see more companies encountering some degree of financial distress. Depending on market conditions and sector-specific pressures – as well as the point at which boards seek appropriate professional advice – this is likely to lead to market participants seeking to restructure (whether or not using formal restructuring processes) in order to allow borrowers the opportunity to trade their way out of trouble and service their debts. Covenant-lite financings will mean triggers that might normally be expected to initiate workout discussions are regrettably delayed. It seems near-inevitable that some difficulties will not be caught early enough for certain borrowers, such that there will be a continued increase in the numbers of formal insolvencies, both on national and international levels.

The UK Insolvency Service's monthly statistics for November 2022 confirm this expectation, with formal insolvencies now up 21% year-on-year, and 35% higher than in November 2019. This is largely driven by liquidations of SMEs - with a number of businesses which have ridden out the pandemic, often with government support, only now realising they are no longer viable now such support has ended (and, in some cases, that their markets have irretrievably changed). The numbers of administrations have increased and company voluntary arrangements (CVAs) remain flat, year-on-year, but overall remain lower than they were before the pandemic.

Since June 2020, there have been 40 "standalone" moratoriums obtained under Part A1 of the Insolvency Act 1986 (i.e. the new process introduced by the Corporate Insolvency and Governance Act 2020). This is a greater uptake than was seen immediately following the introduction of the process; there is now evidence of corporates and practitioners alike becoming more comfortable with the features and practical utility of the process.

In the same period, however, there have only been 12 restructuring plans under Part 26A of the Companies Act 2006. The limited use of restructuring plans seemingly reinforces the notion that they remain largely of the preserve of larger companies with complex, sophisticated financing structures, where the costs involved in going this route are manageable and more proportionate to the compromises sought to be achieved. The cross-class cramdown feature available under restructuring plans represents a potent threat – and, where implemented, has a track-record of delivering successful restructurings in complex structures where previously it may not have been possible given the more rigid approval requirements under traditional schemes. There have been similar innovations in other jurisdictions – including in EU member states, in pursuance of mandatory requirements under the EU Restructuring Directive.

Now, more than ever before, opportunities abound for distressed debtors with an international presence and operations looking to restructure their indebtedness. In complex international restructurings, whether or not such procedures are capable of being a workable solution to implement a restructuring will depend in large part on the extent to which they will be recognised by the courts in key jurisdictions (for example, where the debtor is incorporated or where certain of its assets are located). So far, initial misgivings about a negative "Brexit effect" have proven to be unfounded, in terms of recognition for overseas debtors restructuring in the UK; the UK restructuring market has retained its appeal and its track-record for pushing the boundaries of what is achievable using formal restructuring tools.

Many restructuring professionals have been prophesying a "cliff-edge" for the past few years, in terms of a sudden deluge of insolvency filings, without it ever having materialised in any real sense. The COVID-19 pandemic did not act as the catalyst for global recession in the way originally expected, given the government support that was implemented in different countries across the globe. However, we are arguably now faced with a "perfect storm" with the energy crisis, supply chain issues, conflict, inflation and rising interest rates. In addition to the direct impacts on businesses and their profitability, individuals are facing the repercussions of the cost of living crisis, which is reducing discretionary spending – and, in turn, ricocheting through the economy, impacting businesses again.

Some sectors will likely be hit harder than others. We anticipate that energy-intensive businesses, those heavily reliant on the global supply chain and those reliant on disposable income spend will likely be those hit the hardest; for example, the consumer and retail, manufacturing, transportation and agri/food sectors. In many of these sectors, businesses are facing increased costs and falling demand. However there is the capacity for failures to come from elsewhere; in particular, the combination of recent market turmoil, gaps in regulation and gross mismanagement has resulted in the recent collapses witnessed in the crypto sector, which many are predicting to continue into 2023.

The general market expectation, if a global recession does come to pass, is that insolvency figures will increase. However, this will likely only tell part of the story, as those businesses demonstrating responsible director behaviour which seek help at an earlier stage will maintain access to a greater range of turnaround options and, normally, will have a better chance of being able to restructure consensually or semi-consensually (for example, using a scheme or restructuring plan or one of their international analogues). The timing of a global recession, though, remains uncertain, especially with inflation apparently now easing slightly in the US and the UK. The jury is still out on whether we will see more early-stage attempts to restructure or more wide-scale "hitting of buffers" and only time will tell.

Loan market products to watch out for

- Carbon credit trading and security

From what we see in the market we believe that the voluntary carbon market needs to expand 15-fold by 2030 (and 100-fold by 2050, if we want to achieve net-zero by 2050). That means we can reasonably expect a corresponding level of growth in financings that support this market. For lenders hoping to lead in this space, one of the biggest current considerations is how security can be taken over carbon credits.

Linked to this, the wider environmental products financing piece should continue to be a key theme for next year across the financing market. Given the global energy situation, it also seems obvious that energy and infrastructure sector growth is inevitable.

- Sustainable finance

Sustainable finance has become increasingly mainstream, with sustainable finance instruments, particularly sustainability-linked loans (SLLs), continuing to dominate the market. Indeed, a recent Bloomberg survey suggests that over 50% of loans in EMEA in 2023 will be ESG-related. Of course, this means that borrowers who fail to develop serious sustainability strategies could soon find that financing becomes relatively more expensive and increasingly hard to access.

Borrowers who do participate in sustainable finance will find that the industry standards are being tightened up. The Loan Market Association (LMA) (together with the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association) is in the process of updating the Sustainability-linked Loan Principles, Green Loan Principles and Social Loan Principles. The updated principles, likely to be published in Q1 or Q2 of 2023, are expected to impose slightly more exacting standards on borrowers in an attempt to bring more discipline to the market.

Another LMA initiative which is expected to come to fruition in Q1 or Q2 of 2023 is a rider providing standard drafting for SLLs. This is a welcome development, as it will bring consistency to a market which is developing quickly but in different directions. Each company's sustainability journey is different and there will still be a need to tailor key performance indicators and sustainability performance targets to particular borrowers. However, there is significant efficiency to be had in ensuring, for example, that the same margin ratchet and reporting drafting is generally used in SLLs.

The spectre of greenwashing is never far away in this space – in short, companies saying one thing about their green credentials but doing another. The sustainable lending market is self-policing in that there is no certifying body to go to for approval that a facility complies with the relevant principles – it is for the borrower and lenders (and their advisers) to get comfortable that the principles have been complied with. The self-policing nature of this market is simultaneously a strength (as it has allowed massive growth in a short period) and a weakness (as some companies have not upheld standards). Companies and lenders who seek to cut corners in badging their facilities as "green", "social" or "sustainability-linked" are likely to face scrutiny in the press and potentially in the courts or from regulators in future.

Don't forget

USD LIBOR amendments

The 30 June 2023 deadline for transitioning USD LIBOR loans to SOFR is fast approaching, which means we can expect a sudden rush to amend loan agreements in the first half of 2023. This amendment process can be particularly challenging for emerging markets and ECA/DFI-supported financings. Market participants are therefore urged to commence the amendment process as soon as possible.

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LIBOR transition

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