



NATIONAL RESERVE BANK OF TONGA

Prudential Banking Standard No. 13 - 2021

Syndicated Lending

This Prudential Banking Standard is established under Section 20(3) of the Banking Act 2021 (the Act) and sets out the minimum standards which banks operating in Tonga should adopt for the identification and management of risks associated with syndicated lending.

In preparing this Prudential Banking Standard, reference has been made to the recommendations of the Basel Committee on Banking Supervision and other international sound practices and standards.

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1. Introduction

1.1 Background

- 1.1.1 Syndicated lending constitutes a significant type of business for some Banks. The participation of multiple Banks adds a layer of complexity to such activity.
- 1.1.2 Syndicated loans are not necessarily riskier than other types of lending. Indeed, the distribution of lending among participants is designed to reduce risk by sharing it. Furthermore, the presence of multiple Banks strengthens their negotiating power with borrowers by harnessing the collective wisdom and experience of the participants and enables risk mitigating measures such as protective covenants to be put in place. Nevertheless, particular types of risk may be incurred, depending on what role a Bank plays in a syndicated loan.
- 1.1.3 This Prudential Banking Standard serves to guide Banks on how to manage syndicated loans and on the types of safeguards, processes and procedures which is expected to be in place in Banks that engages in such business.
- 1.1.4 This does not represent an exhaustive checklist but rather is intended to indicate the types of measures Banks should consider.

1.2 Features

- 1.2.1 The term "syndicated lending" in this refers to arrangements whereby multiple Banks advance funds jointly to one or more borrowers (e.g. in the case of lending to different funding vehicles within a borrowing group). For any proposed lending that satisfies the features of a syndicated loan, it must be reported to the Reserve Bank for review and endorsement with ALL related documents as specified by the Reserve Bank.
- 1.2.2 A loan syndication lender can only be performed by banks that are formally licensed and supervised by the Reserve Bank under relevant laws and regulations.
- 1.2.3 While the structure, pricing, repayment schedule and other terms of syndicated loans can vary, the following common characteristics are usually present:
 - a. syndicated loans are normally governed by one set of documentation describing the rights and obligations of the signatories - the borrower and all the Banks (or syndicate members). The latter's obligation to lend is usually several;
 - b. one or more Banks are mandated by the borrower to arrange credit facilities on terms agreed between the arranger and the borrower. The arranger may underwrite (i.e. undertake to provide) all or part of the facility amount;
 - c. typically, the total amount of a syndicated deal is relatively significant, even though the credit extended by each participant does not generally exceed what it would be prepared to lend on a bilateral basis;
 - d. the tenor may well be medium- or long-term, although short-term (under one year) facilities are also common, particularly for trade-related transactions;
 - e. the credit facility typically takes the form of a term loan, a revolving credit or a standby letter of credit;
 - f. syndicated lending involves multiple parties (also see subsection 1.3 below), e.g., arrangers, underwriters, sub-underwriters, agents (facility and security), legal counsel and participating Banks. There is no standard terminology, however. Titles such as co-arranger, lead manager and co-lead manager are also found. Such titles do not necessarily correspond to or define the tasks carried out by the parties bearing such titles.

1.3 Multiple parties

- 1.3.1 Although the functions of the arranger in syndicated lending vary according to the set-up of each deal,

they normally include:

- a. structuring and negotiating the terms of the transaction with the borrower;
 - b. preparing the information memorandum or package for potential Banks;
 - c. if applicable, forming the underwriting group;
 - d. developing a syndication strategy, including the strategy for soliciting participants and securing their commitments;
 - e. coordinating the drafting of documentation by legal professionals; and
 - f. handling signing of the facility and any publicity.
- 1.3.2 Co-arrangers may support the arrangers in carrying out the above functions, or may simply be accorded their titles by virtue of the scale of their participation.
- 1.3.3 As the term indicates, underwriters undertake to provide all or part of the syndicated loan if any portion remains unsold, subject to satisfactory documentation. Sub-underwriters underwrite up to the limit of their sub-underwriting. Underwriters and sub-underwriters may also be arrangers, lead managers, co-arrangers or co-lead managers.
- 1.3.4 The functions and obligations of the agent² are outlined in the facility agreement. They normally include:
- a. obtaining and perfecting any collateral (see para.1.3.5 below);
 - b. verifying compliance with pre-conditions by the borrower (and guarantor, if appropriate) based on guidance given by legal counsel and issuing confirmation thereof to the Banks;
 - c. vetting any drawdown notices from the borrower and informing the Banks;
 - d. coordinating payments by the Banks and re-routing the funds to the borrower;
 - e. distributing repayments by the borrower to the Banks; and
 - f. advising the Banks of any default, actual or potential, by the borrower of which it becomes aware as regards to repayments and compliance with covenants and other terms of the loan agreement. Banks becoming aware of any default should also inform the agent so that the latter can inform the other Banks.
- 1.3.5 The agent usually performs the function of obtaining and perfecting any collateral with the assistance and confirmation of legal counsel appointed on behalf of the arranger and Banks. A security agent may be appointed to hold or administer collateral on behalf of the Banks.
- 1.3.6 The Banks will require the borrower's auditors, whose appointment must be satisfactory to them, to monitor compliance with financial covenants and to examine compliance certificates.
- 1.3.7 A syndicate member which is not engaged in the above functions will mainly be a participating lender. The member may employ its own legal and financial advisors to give professional advice on the deal, in addition to those appointed to advise the syndicate. A syndicate may also appoint other professional advisors such as valuation, insurance and engineering companies.

1.4 Risk implications

- 1.4.1 Given the above characteristics, Banks engaging in syndicated lending business may be exposed not only to credit risk but also to market risk, interest rate risk, liquidity risk, operational risk, legal risk, reputation risk and strategic risk (also see section 2 below). These risks are not specific to syndicated lending (see para. 1.1.2 above) but the nature or degree of risks assumed may be affected by the special features of syndicated lending.
- 1.4.2 Banks' risk exposures in a syndicated deal will vary, depending on their particular role in the transaction and the extent of their participation. Banks should therefore understand the risks arising from these roles and have systems in place to manage and mitigate such risks.

2. RISKS IN SYNDICATED LENDING

2.1 *Credit risk*

- 2.1.1 Credit risk is incurred by Banks lending under a syndicated transaction. Although the creditworthiness of the borrower may be good - usually only the more creditworthy borrowers have access to the syndicated loan market - the inherent credit risk will tend to be higher where the tenor of the obligations is longer and the total size of the credit extended to the borrower is relatively large. This is particularly true in cases where the deal amount goes up simply because of over-subscription for the syndicated transaction.
- 2.1.2 Regardless of their extent of participation, syndicate members (i.e. Banks) should not rely solely on the credit appraisal prepared by the arranger. Each member should perform its own independent analysis with respect to the credit quality of the borrower and the suitability of the deal in relation to its own risk appetite.

2.2 *Market risk*

- 2.2.1 The level of market risk in syndicated lending depends on the level of the BANK's involvement in a deal. Banks acting as underwriters are subject to market risk because, although they intend to sell all or part of their participations, they may end up with an unsold portion on their books for a period of time pending eventual sale, particularly if:
 - a. due to unforeseen circumstances, the borrower's financial condition deteriorates to such an extent as to affect an underwriter's ability to distribute the unsold portion; or
 - b. market interest rates move adversely. As the majority of syndicated loans are priced on a floating-rate basis, this would be relevant in respect of:
 - i. fixed-rate deals; or- situations where market spreads widen after a syndicated transaction is concluded. This would render the deal unattractive to potential Banks.
 - ii. It is usually the case that the period between underwriting and completion of syndication is relatively short and the extent of the risk is therefore limited. Nevertheless, it is customary to cater for this risk by "material adverse change" or "force majeure" clauses in the documentation, covering market disruption or deteriorating credit circumstances, which would enable underwriters to restructure or cancel a deal.
 - iii. Banks should have policies and procedures to cater for such situations, including documentation standards, hedging for interest rate and credit risks (e.g. by use of derivative instruments), if appropriate, and reporting to senior management on any significant unsold sticks.

2.3 *Interest rate risk*

- 2.3.1 Depending on how a deal is priced and funded there may be different degrees of interest rate risk. It is incurred by Banks which have provided lending commitments under legally binding documentation. Banks should ensure that such risk arising from syndicated lending activities is properly managed at the product level or integrated into their overall interest rate risk management process. The handling of such risk is usually the responsibility of the Asset and Liability Committee.

2.4 *Liquidity risk*

- 2.4.1 As a matter of prudent management, Banks should manage their liquidity positions as a whole by limiting the amount of longer term syndicated lending and other types of long-term lending (e.g. residential mortgage loans) to a conservative percentage of their stable funds⁴ so as to avoid creating significant maturity mismatches.
- 2.4.2 Banks should avoid relying excessively on short-term deposits to fund long-term loans

2.5 Operational risk

- 2.5.1 Operational risk in syndicated lending is incurred by the Banks but it also affects the agent as the latter is responsible for handling certain aspects of credit administration. Errors due to oversight or negligence, e.g. in giving timely advice to syndicate members, in arranging drawdowns, in refixing interest rates or in effecting interest and principal payments to syndicate members, can be costly in terms of both monetary compensation and reputation.
- 2.5.2 Banks taking on the role of agent should ensure that their systems are adequate and their staff are capable of carrying out their role efficiently. They may be required to compensate syndicate members if, for example, funds are disbursed late or to the wrong parties. They should also cater for counterparty risk on settlement of payments.

2.6 Legal risk

- 2.6.1 Legal risk is incurred by underwriters, Banks and the agent once the documentation is signed.
- 2.6.2 Because of the scale, term and complexity of syndicated lending, with multiple parties involved, legal arrangements need to be as watertight as possible. Experienced staff of the arranger should work closely with legal counsel to ensure that the interests of Banks are adequately protected. This should be by negotiating with the borrower to ensure that appropriate and enforceable covenants are included in the information memorandum and that they are reflected in the syndicated loan agreement along with suitable protective clauses.
- 2.6.3 All relevant documentation should be circulated to syndicate members for review and comment before such documentation is signed. It is up to prospective Banks to decide whether those covenants are adequate and in general to decide whether the deal is consistent with their risk appetite.

2.7 Reputation risk

- 2.7.1 If a high profile deal encounters problems, it is primarily the reputation of the arranger of the deal that suffers. There may also, however, be some effect on the reputation of ordinary syndicate members. Syndicated lending tends to have a higher public profile and it is more difficult to control the information flow when there are multiple Banks. Banks, whatever their role or level of involvement in a deal, should have arrangements in place and experienced staff assigned to handle corporate communications in relation to syndicated lending. There will need to be a degree of coordination among various syndicate members so that media relations can be handled effectively.
- 2.7.2 As it is also in the borrower's interest that media relations are handled effectively, Banks acting as arrangers should coordinate with the borrower to ensure that there is a mutually satisfactory approach for dealing with media inquiries.

2.8 Strategic risk

- 2.8.1 Banks should consider whether the projected extent of their involvement in syndicated lending is compatible with the overall strategic goals of the organisation and whether they have the requisite resources to achieve targets set for this activity.

3. CONTROLS OVER SYNDICATED LENDING

3.1 Policies and procedures

- 3.1.1 Every Banks involved in syndicated lending should have adequate policies and procedures for conducting such business.
- 3.1.2 The policies should set out the Bank's strategy for such business, its risk appetite and tolerances and the parameters under which such business is done. These would normally include:

- a. the type of role the Bank may take on in syndicated lending (see subsection 1.3 above);
 - b. within its overall credit limits, limits for syndicated lending with sub-limits according to different criteria, e.g. underwriting and sub-underwriting;
 - c. the parties or committees authorized to approve such lending and ancillary matters such as documentation, pricing and other terms;
 - d. requirements for and acceptable types of collateral;
 - e. lists of lawyers acceptable for drawing up documentation;
 - f. minimum standard provisions (e.g. protective clauses and covenants) required in documentation;
 - g. guidance on pricing (e.g. minimum acceptable level of spread over funding costs and the level of authority required to approve a spread lower than the minimum);
 - h. policies and procedures for managing the eight risks described in section 2 above; and
 - i. requirements for monitoring, reporting and independent reviews of syndicated lending activity.
 - j. the type of role the Bank may take on in syndicated lending (see subsection 1.3 above);
 - k. within its overall credit limits, limits for syndicated lending with sub-limits according to different criteria, e.g. underwriting and sub-underwriting;
 - l. the parties or committees authorized to approve such lending and ancillary matters such as documentation, pricing and other terms;
 - m. requirements for and acceptable types of collateral;
 - n. lists of lawyers acceptable for drawing up documentation;
 - o. minimum standard provisions (e.g. protective clauses and covenants) required in documentation;
 - p. guidance on pricing (e.g. minimum acceptable level of spread over funding costs and the level of authority required to approve a spread lower than the minimum)
 - q. policies and procedures for managing the eight (8) risks described in section 2 above; and
 - r. requirements for monitoring, reporting and independent reviews of syndicated lending activity.
- 3.1.3 Banks engaged in syndicated lending mainly as ordinary members may have the above policies incorporated into their general credit policies which are subject to periodic review and approval as required in subsection 3.1.
- 3.1.4 Banks actively involved in syndicated lending as arrangers or underwriters should have specific policies and procedures covering such business, documented in writing and approved by the Board of Directors, the Credit Committee or senior management with delegated authority. They should also set up dedicated teams responsible for managing the syndication process and associated underwriting risks.

3.2 *Credit appraisals, review and monitoring*

- 3.2.1 In addition to conducting its own due diligence as mentioned in para. 2.1.2 above, each syndicate member should perform its own periodic credit review and monitoring to identify unusual developments and, if appropriate, initiate necessary actions to protect its interest. Refer to Prudential Banking Standard 1 Asset Quality and Prudential Banking Standard 2 Credit Risk Grading System.

3.3 *Documentation*

- 3.3.1 Due to the multiple parties associated with syndicated lending it is customary for such deals to be tightly documented. In addition to agreements between the participating Banks and the borrower (and guarantor, if any), the respective roles and responsibilities of all participating Banks, e.g. the agreement between the agent and other syndicate members, should be carefully drafted.
- 3.3.2 It is up to individual Banks to decide what provisions are required to be included in the agreements. It is, however, customary for emphasis to be placed on covenants to protect the interests of lenders.
- 3.3.3 Documentation should also cover provisions dealing with issues such as:

- a. tax gross-ups (the obligation of the borrower to increase any payment on which withholding tax or other deductions are levied so that lenders receive the amount they were originally due under the terms of the documentation);
- b. increased costs (the obligation of the borrower to indemnify lenders where market circumstances make it more expensive for lenders to maintain their participations); and
- c. illegality (where any provisions of the documentation become illegal or unenforceable, the survival of the remaining terms)

3.4 *Monitoring compliance with covenants*

- 3.4.1 Covenants may be affirmative or negative. The former relates to pledges to satisfy certain requirements, e.g. undertakings to keep key assets adequately insured and to effect repayments on time. Negative (or restrictive) covenants prohibit or require the borrower to refrain from certain practices such as selling or transferring key assets, from committing any default under other terms of the agreement, from falling below a minimum gearing ratio, from committing actions that diminish the value of the collateral or endanger the financial stability of the business, etc.
- 3.4.2 Violations of covenants may constitute events of default and accelerate repayment under the agreement. Banks should not relax covenants without careful considerations and reasonable basis in consultation with their lawyers.
- 3.4.3 All syndicate members should have proper systems in place to monitor for themselves the compliance by the borrower with the covenants of a syndicated loan agreement. For example, they may set out their own schedules for regular follow-up of information from borrowers. If any syndicate member is aware of any breach of the covenants, it should report the breach promptly to the agent for relaying to other members. The breach should be investigated with appropriate actions taken, e.g. top-up of collateral, to protect the interests of syndicate members.
- 3.4.4 If the task of monitoring compliance with covenants is delegated to the agent, other syndicate members should satisfy themselves that the agent is capable of performing this important task and they should also carry out their own periodic verifications to spot check whether the agent is monitoring properly.

3.5 *Problem credit management*

- 3.5.1 As with any lending, syndicated loans may go into default. With the presence of multiple lenders, it is particularly important that they react responsibly in such situations so that the interests of lenders, borrowers and other parties are properly safeguarded. In this regard, Banks are encouraged to observe the Prudential Banking Standard 1 Asset Quality, Prudential Banking Standard 2 Credit Risk Grading System, Prudential Banking Standard 6 Capital Adequacy and Prudential Banking Standard 10 on Large Exposures.

COMPLIANCE WITH PRUDENTIAL BANKING STANDARD NO. 13

This statement is effective from **1st July 2021**. Non-compliance with the requirements of this Prudential Banking Standard will be subject to corrective actions as provided under section 39 of the Banking Act and the administrative penalties outlined in Prudential Banking Standard No.3 Administrative Penalties.

4. EFFECTIVE DATE

This guideline applies to Banks licensed under the Act and will be effective from **1st July, 2021**