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# Risk Sharing – A Rising Trend

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We are increasingly hearing from bank and non-bank lenders looking for ways to de-risk either all or, more usually, a portion of their exposure under a particular facility. It is perhaps a symptom of the current economic climate that these requests are becoming more frequent, particularly with respect to structured NAV trades.

Given this increased interest in the availability and typical operation of risk sharing arrangements, this week we are collaborating with Assia Damianova, a Special Counsel in our structured finance team who deals frequently with these products, to look at the options available to lenders in the European fund finance market.

Lenders look to share risk for a variety of reasons, which can include (i) credit risk mitigation, (ii) capital relief and (iii) compliance with internal policies relating to country limits, single obligor limits or corporate/sponsor group limits.

The aim of this note is to highlight that while the commercial effect of many risk sharing arrangements is similar, the legal and UK/EU regulatory view of the relevant instrument may be very different. This note does not intend to cover any capital relief issues for banks, which are a separate (and vast) area, but rather focuses on some of the key methods for de-risking with respect to a particular trade or obligor. The key methods of de-risking that we will discuss are participations (both funded and unfunded), guarantees and total return swaps, and we will also look briefly at how insurance considerations can be relevant to these products.

**Participations**

A participation can be used for a variety of reasons. For example, a participant may wish to obtain credit exposure to the performance of the borrower, while being unable to comply with the lender restrictions in the loan agreement, or wishing to achieve, vis-à-vis the lender of record, a different risk profile compared to that on the face of the loan (for example, a different interest rate floor, or a different duration of the exposure).

There are two types of participations.

Under a *funded participation*, the participant (the party gaining exposure without owning the loan) funds the grantor (the lender of record) so it can fulfil its obligations under the facility when a loan is drawn.

The grantor passes to the participant the interest and principal, when received from the borrower, and pays a fee. The participant's return is conditional on the borrower complying with its payment obligations under the loan agreement and on the grantor complying with its payment obligations under the participation agreement.

Under a *risk participation*, the participant agrees to cover, up to a pre-agreed level, amounts that the grantor does not receive following a payment default under the loan agreement and, in return, the grantor pays a fee to the participant.

*Legal Issues*

English law-governed participation agreements are back-to-back funding arrangements that do not change the ownership of the underlying loan or the interest and other payments made under that loan. The participant assumes the double credit risk of a default by either the borrower or the lender of record. Indeed, the LMA produced a paper in

2010 called *Funded Participations – Mitigation of Grantor Credit Risk,* which provides trade parties with possible steps on how to mitigate the grantor credit risk.

**Guarantees**

Guarantees can also be used as a method of de-risking a trade. In the context of risk sharing, a third party guarantees performance by the borrower to the lender of record in return for a guarantee premium. There are a number of legal pitfalls when drafting guarantees: under English law, a guarantee is a secondary obligation in respect of the primary obligations of a third party (*i.e.*, the borrower) and is contingent on the validity and scope of the underlying guaranteed obligations. Consequently, there is a legal risk that a guarantee can be inadvertently discharged in certain circumstances, such as where amendments to the guaranteed obligation are made without the consent of the guarantor. There are also numerous other defences available to the guarantor that can vary in their strength and application depending on the circumstances.

**Total Return Swaps (TRS)**

Another option available to lenders of record to de-risk their position is a Total Return Swap (or TRS). Under a TRS contract, the total return payer agrees to pay the TRS receiver the "total return" on an underlying asset − in our case, a loan − while being paid interest returns from the other party – the total return receiver.

Through a TRS, the total return receiver (in our case, the party that comes in to share the risk): (a) receives interest payments on the underlying loan, plus any appreciation in the market value of the loan, and (b) pays interest (in the nature of a funding charge), plus an amount equal to any depreciation in the value of the loan. In other words, those payments, synthetically, approximate ownership of the asset.

The total return payer (in our case, the lender of record) buys protection against a possible decline in the value of the loan by agreeing to pay all the future positive returns of the loan to the TRS receiver, in exchange for floating streams of payments and the above-mentioned depreciation in the loan value. In other words, those payments, synthetically, achieve credit protection in respect of the asset.

One of the benefits of a TRS is operational efficiency – for example, the total return receiver does not get involved in interest collections, payment calculations, and reporting that are required at the loan level, and neither does the total return receiver have to lay out substantial capital to purchase the loan.

*Legal and Regulatory Issues*

Unlike the participations discussed above, a TRS is a derivative and, therefore, it is a "financial instrument" under MiFID and activities relating to the TRS may therefore be "regulated activities" under MiFID requiring due authorisation (unless exemptions or exceptions apply). Separately, under EMIR**[1]** (which has an extra-territorial reach), a TRS may, depending on the parties involved, be subject to a number of reporting and risk mitigation requirements, including the posting of regulatory margin.

**Insurance − Different Interpretations**

The boundaries between credit insurance, a participation agreement, a guarantee and TRS may get blurred, especially in bespoke and highly negotiated transactions. Therefore, courts or a regulator may interpret the arrangements differently than the contractual "label" attached by the parties.

For example, underwriting and brokering insurance contracts is a regulated activity under the Financial Services and Markets Act 2000, and the entity conducting such activities may need to be subject to prior authorisation by the PRA. Besides the issue of regulatory authorisation, contracts of insurance are subject to separate legal rules, both under statute and common law. One consequence of those is that an insurance provider would be able to assert a greater number of defences to payment. Separately, certain insurance products are subject to insurance premium tax.

English case law shows that certain types of contracts can be interpreted as either a contract of insurance or a contract of guarantee, and the court will look at the substance of the contract as a whole, without there being a single factor that can tip the arrangement into one category of agreement or another. Therefore, institutions should carefully consider all relevant features of the arrangement when structuring and drafting the de-risking instrument, and take appropriate legal advice. For example, and not as an exclusive list, some of the features of the risk sharing arrangement to consider are: (i) which party assumes the risk of profit and loss; (ii) does the party entitled to claim cover need to suffer actual loss, or could the loss be suffered by another member of the group; (iii) does the contract contain provisions consistent with insurance principles, including the duty of utmost good faith, (iv) is there a premium payable by reference to the probability of the occurrence of a loss; and (v) does the protected party have extensive disclosure obligations.

**Facility Documentation Considerations**

In the facility agreement itself, the main points for consideration for the lender of record and participant are (i) whether a de-risking transaction of the type contemplated is permitted under the lender transfer provision of the facility and (ii) whether information sharing with the counter-party is permitted under the confidentiality provisions.

The lender transfer provisions are increasingly a point of focus in facility negotiations, with certain sponsors seeking to apply consent or consultation requirements for sub-participations generally or for sub-participations that transfer voting control. We have also seen some sponsors go further and seek to regulate the use of other de-leveraging products, such as those described above, through a variety of methods.

The LMA confidentiality provisions are also relevant, as the participant (and its counsel) will generally expect to be provided with the finance documents and may also require access to the documentation provided to the lenders through the periodic reporting under the facility. As with the transfer provisions, we are therefore seeing increased focus on the confidentiality provisions from sponsors and lenders alike.

**Conclusion**

Economically, different types of risk sharing instruments may produce similar results, but each product’s legal, regulatory and tax analysis may differ significantly. Therefore, the structuring and legal documentation of risk sharing arrangements requires careful balancing of the tensions between each product, as well as sound-proofing against the risk of legal or regulatory re-characterisation.

**[1]** Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.