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House of Commons
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JG/fm/0620jmcf

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Dear Mr McFall

Treasury Select Committee inquiry into Private Equity: Covenant-lite loans

My purpose in writing is to highlight that there is a risk of misunderstanding over the implications of the use of "covenant-lite" loans. Some press reports have been misleading or alarmist.

I attended the Treasury Select Committee hearing on June 12th when some speakers spoke as though covenant-lite loan agreements were actually covenant free.

In fact such loans do still have covenants and default provisions. These are in some ways more like those associated with (high yield) bonds rather than with bank loans. Many of the non-banks now making such loans are long-standing bond investors and accustomed to that level of provision. The agreements are highly negotiated.

The covenants and restrictions remaining are in most cases actually very restrictive: much more so than an investment grade borrower would agree to. Borrowers may get a bit more flexibility, but are not un-constrained.

The effect of covenant-lite loans is more nuanced than reported.

We are dealing with highly-leveraged, lower-credit standing borrowers. By definition, some low-credit standing borrowers are expected to default. That is not a cause for concern. If changes radically increased the number of borrowers that might be expected to fail, that might be a cause for concern.

The overall effect is difficult to judge. Some of covenant-lite provisions may serve to help companies with failing credit standing to recover. Some give more flexibility to companies until more obvious failure – so the situation can be more serious before they have to involve the lenders. But it does not seem at all obvious that covenant-lite loans, so far, increase the chance of ultimate insolvency.

To illustrate the sort of difference covenant-lite currently makes, I can take just two of the many types of clause found in highly leveraged loan agreements:

- **Restrictions on acquisitions, disposals, secured or priority borrowings**

  When highly leveraged borrowers dealt mostly with banks, restrictions from this type of covenant were more easily acceptable. Exceptions were, in any case, included in the agreement for small or routine items. The process of discussion and agreement with the bank group over sensible developments otherwise caught by the restrictions was relatively accessible.

  The newer type of non-bank lender is not so accessible.

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Such a non-bank lender may be unable to receive the type of non-public information needed to justify proposed company actions or even that necessarily embodied in knowing that the company seeks approval to an action. Some lenders are not set up to be able to make decisions in this area, and remain silent. Those that do consider a request probably want to be paid in order to make any change.

This is more like the situation a company faces with bond investors – who may often be anonymous and cannot be consulted for that reason. Changing bond provisions is time consuming, expensive and without clear prospect of success.

So, increasingly, highly leveraged loan agreements contain more generous exceptions for company action. It is also made easier to get lender consent to change conditions. Lenders who have given notice they are not to be consulted or who are silent on a question can be deemed to consent or to be excluded from calculations of the overall syndicate percentage accepting a change ("snooze you loose"). A borrower may be able to bring in another lender in substitution for an objecting lender ("yank the bank").

- **Restrictions on the total amount of debt and/or financing costs** ("fixed charges")

  Restrictions continue in covenant-lite loans, but with changes.

  Some expenses may be excluded from calculations of income, and some types of debt may be excluded from calculations together with associated interest or other fixed charges.

  The restrictions on the total amount of debt or financing costs are likely to be expressed only to prevent the taking-on ("incurrence") of extra debt if the limit is breached – rather than being an agreement to "maintain" the company within the limits at all times. So covenant-lite has "incurrence" rather than "maintenance" covenants.

  Also, injection of new equity from shareholders may be taken as income or cash flow if a debt to income or cash flow covenant would otherwise be broken ("equity cure").

Thus, covenant-lite loan agreements are more relaxed than previous practice for highly levered loans, but significant covenants and restrictions continue to apply.

There may be implications for the macro-economy from shifts in the type of lender to (highly leveraged) companies as more non-banks are involved. But covenant-lite loans don't seem to carry the implications which would stem from unrestricted, unconditional lending.

This letter is on the record and may be freely quoted. A note about The Association of Corporate Treasurers is appended.

Yours sincerely

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The Association of Corporate Treasurers

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The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

For further information visit http://www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

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