Crisis management

WITH RELATIONSHIP BANKING NOW HAVING MORE RESONANCE FOR BORROWERS THAN AT ANY TIME IN THE PAST 30 YEARS, **IAN FITZGERALD** CONSIDERS HOW CORPORATES CAN BETTER MANAGE THEIR BANK RELATIONSHIPS IN A WORLD OF CONSTRAINED CAPITAL.

Last year was one of unprecedented difficulties for the loan market as the fallout from the credit crunch, which first reared its head in the middle of 2007, led to a wider global financial crisis. The complete loss of confidence in the financial system ripped apart institutional and in some cases sovereign balance sheets, resulting in a series of enforced consolidations and recapitalisations across the banking sector. The capital rationing and deleveraging which subsequently followed made it very difficult to establish any sort of consistency in the loan market.

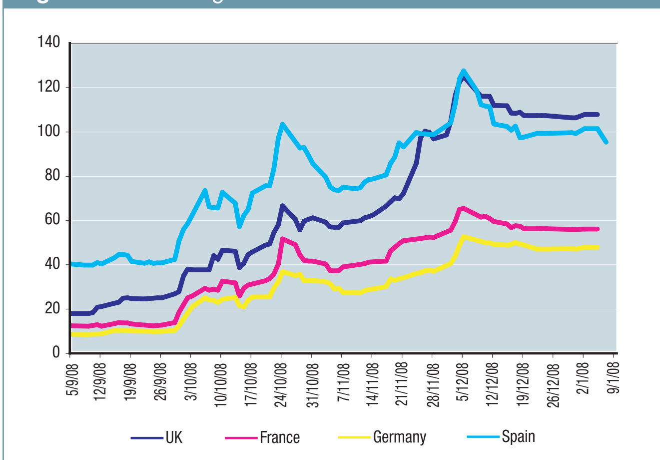
This aggravated the already frozen interbank market, pushing bank funding costs up further and leading to an increase in loan pricing. It is now clear to all market participants that unfettered access to capital, flexible loan structures and the historically low pricing of credit risk are all luxuries from a bygone era.

Transaction pricing is now more a function of liquidity (and cost of funds) than credit risk and current appetite for lending is still heavily influenced by each bank's underlying capital constraints.

MARKET DYNAMICS In an attempt to restore confidence and to free up the credit markets at the back end of 2008, governments and central banks flooded the financial system with hundreds of billions of dollars in liquidity and guarantees. While such actions have helped thaw the interbank lending market to a point, the impact on the loan market itself has been limited as the large increase in government bond issuance has forced up bank funding costs (see Figure 1).

According to data from Reuters, loan volumes in Europe, the Middle East and Africa hit a four-year low of $876bn in 2008. The leveraged market remains in a state of paralysis and M&A activity has reduced considerably, notwithstanding a number of jumbo transactions that have taken place, such as InBev's record $45bn loan backing its acquisition of US brewer Anheuser-Busch.

Figure 1: Sovereign CDS



In fact, there are a number of examples of transactions in the market that are struggling. A typical big-ticket deal that was rated Aa1/AA-/AA- paid 100 basis points over Libor (almost eight times as much as two years ago) on a one-year tranche, but even at this pricing the deal struggled in syndication as demand towards the end of the year receded.

Across the market as a whole, facility structures have tightened with a greater emphasis on documentation (flex, material adverse change clauses, market disruption clauses) and appropriate financial covenants.

With this in mind, lenders are focusing acutely on reducing available headroom in loan structures by incorporating a larger term loan element to reflect the core borrowing levels of corporates.

This move by lenders is not only a means of making funding more efficient – at current pricing levels it makes no sense to pay for something that will not or may not be used – but is also encouraged by Basel II which favours:

- shorter tenors;
- high quality credits; and
- term loans (which are more efficient from a capital allocation perspective).

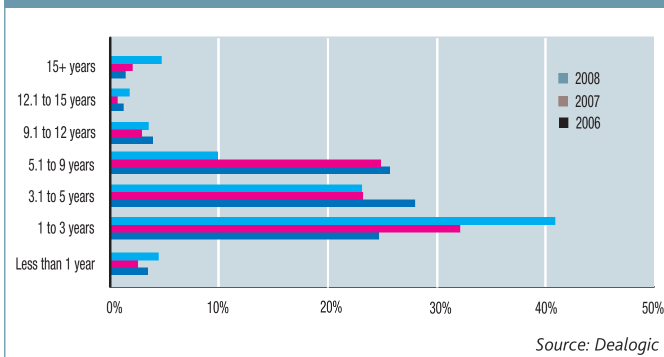
A further impact of Basel II and the banks' reduced appetite for risk is the trend for a shortening of loan tenors to one and three years. According to Dealogic, 77% of all loans signed in the EMEA zone in 2008 have been for maturities of five years or under (see Figure 2), compared with 65% the previous year. Looking more closely, loans with a maturity of between one to three years accounted for 46% of total 2008 EMEA volume, which was an increase from 36% in 2007.

So what does all of this mean for borrowers? And how should they react to these structural and pricing changes?

WHAT NEXT? With suggestions that a downturn will last for the first half of 2009, the impact will create a significant uptick in defaults and the amendments, waivers and restructurings that will inevitably follow.

Given the significant volume of debt due to be refinanced in 2009, not to mention the unknown number of refinancings that will be

Figure 2: Maturity profile of EMEA loan market



Source: Dealogic

triggered by further covenant breaches, the loan market is expected to remain overcrowded and constrained into 2009. Should the bond market remain closed, there will be additional pressure on the loan market at a time when liquidity is already constrained, further bank consolidation is on the cards and regulation is forcing banks to reduce their risk profile. Corporates will therefore need to be proactive, adaptive and open-minded in terms of securing financing in 2009, and ultimately change their assumptions about the borrowing that evolved over the credit boom.

The importance of borrowing relationships cannot be overemphasised. Borrowers need to maintain an active dialogue with their banks in order to understand the prevailing market dynamics and the requirements of their lenders to gain credit commitments – which include deleveraged balance sheets, tighter documentation and an equitable distribution of ancillary business.

On a more granular level, selecting market leading participants that are able to commit balance sheet to a financing exercise is more important than ever. Lending has moved away from a pure investment-banking/advisory driven market. This is gradually being replaced by traditional lending banks able to blend both advisory and balance sheet commitment – a characteristic that is increasingly seen as the value-add in loan transactions.

More than ever banks will require excellent reasons to keep their capital on the table and support companies through the cycle. As a result, the concept of relationship banking has never been so sharply in focus.

None of us wants to have issues about pricing, lengthy conversations about documentation or see companies collapse. Ultimately, banks are constrained by the marginal cost of getting the last bank into the deal and the increased cost of government borrowing. With this in mind, our aim is to provide the best advice on transactions to ensure they satisfy the core funding requirement of the corporate in a difficult market and at an optimal price.

It is worth remembering that our business, particularly in the corporate space, is about working with our customers to support them through the cycle, ensuring that they are adequately and appropriately funded. This in turn enables corporate management teams to focus on what they do best: running a profitable business.

Finally let us not forget that the loan market, like other financial markets, is cyclical. In time, conditions will inevitably improve. As soon as they do, treasurers will begin to see pricing and structure move back in their favour.

Ian Fitzgerald is managing director and head of loan syndicate at Lloyds TSB Corporate Markets.

Structural shift in banking

THE CAPITAL MARKETS HAVE REFOCUSED ON RELATIONSHIPS AS BANKING HAS GONE BACK TO BASICS. **MARK GRANT** FORESEES THE RETURN TO REASONABLE LEVELS OF CREDIT RISK AND ASSET PRICING, LEVERAGE MULTIPLES AND LENDING COVENANTS.

Who would have thought 12 months ago that the capital markets could reach the state of disarray that was witnessed in the second half of 2008? Bond markets closed, structured credit was fundamentally altered, equity market volatility reached unprecedented levels and the loan markets were paralysed by capital constraints in the banking sector. If anything can be said with any degree of certainty it is that last year sorted out the through-the-cycle relationship lenders from the asset players that have dominated the market over the past 10 years.

The market has refocused on relationships. Long-term lending has by necessity become all about ancillary business, as banks struggle with higher costs to funding and internal capital constraints. Conservatism and prudence have returned to favour as the key tenets of banking while financing has become the great worry for corporate treasurers.

At Lloyds, the challenging conditions have presented an opportunity to cement our position as a tier 1, multi-product bank to our corporate and institutional partners. A return to back-to-basics banking will see credit risk and asset pricing, leverage multiples and lending covenants return to reasonable levels. Companies will focus on managing their risk profiles and strengthening their capital structures at a time when banks will be looking much more earnestly at their own exposure to sectors, asset classes and cyclical businesses.

Deleveraging will undoubtedly continue, and corporates will require a lot more from their banks than just lending facilities. A move towards partnership approaches should take hold as companies require holistic capital structure support spanning credit, equity, asset-based and securitisation products.

Mark Grant is head of capital markets at Lloyds TSB Corporate Markets.