Borrowers brace themselves for lender dialogue

TREASURY, RISK AND FINANCE PROFESSIONALS ACT

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Borrowers are briefing themselves and taking legal advice in order to be prepared if things go wrong.

Treasurers working in companies that put in place adequate credit facilities a year or more ago must be feeling their good treasury management has paid off. Generally this is what most blue chip companies did. Even in these well managed companies there are significant concerns, however. Will the markets still be shaky when I need to refinance? Could I raise extra funding for a new acquisition? What is happening to pricing of new deals? Will the lenders be trying to invoke market disruption to increase costs immediately? And even the once unthinkable: what if my lenders fail to perform on their obligations?

Fortunately, pre credit-crisis, most borrowers could not resist the cheap funding facilities available. Indeed, the banks were positively encouraging companies to sign up to ever larger amounts and at higher leverage for longer terms.

Not so now. We have seen a complete absence of non-bank lenders from primary markets recently. The only banks that seem to remain willing now are those where there have been and remain strong relationship connections. This triggers the thought as to whether, where the amounts are not too large, we will see a return to more companies seeking to finance themselves with a series of bilateral facilities. One company treasurer who has always preferred the more direct relationship in a bilateral is reporting relatively little problem in renewing facilities. Bilaterals can have the added advantage that they need not all expire at the same time.

Whatever the trend, loan market conditions are torpid but there is a glimmer of optimism and deals are still being done.

Loan terms and conditions

Much will be changing for new deals, but even for pre-existing facilities we are seeing debate around critical elements. Borrowers are briefing themselves and taking legal advice in order to be prepared if things go wrong. Companies are now nervous about banks' ability to lend. Borrowers have realised that in loan agreements there is a complete absence of termination provisions applicable to the lenders. ISDA swap agreements are notoriously difficult to follow but at least all their provisions tend to be reciprocal. Going forward, some termination provisions binding on the lenders are desperately needed. At the very least it is necessary to remove the possibility that the borrower ends up paying commitment fees to a lender in administration that is clearly unable to perform its lending obligation. Such a lender must no longer count in any voting calculation. Calls for inserting the "Snooze you lose" and "Delay and it's OK" or "Yank the bank" clauses into loan agreements may become more likely even in investment grade loans.

Post Lehman

The collapse of Lehman has triggered thoughts about taxation. What happens if a foreign lender ceases to be carrying on a business in the UK and interest can no longer be paid gross? On current wording gross-up is required. Borrowers will look for a no-gross-up clause for defunct lenders. Likewise, the provisions on replacement of the agent need to be amended to cater for an easy procedure should the agent go into administration.

And if there are drawn advances from a lender that goes into administration, borrowers will look for automatic set off between one draw-down period and the next.

LIBOR/EURIBOR and market disruption

During October a hot topic was market disruption and cost of funding for lenders. Most agreements include a clause allowing lenders to substitute their own cost of funds in place of LIBOR or EURIBOR (henceforth 'LIBOR') if more than a stated percentage of lenders (often 30%) assert that their true cost of funding is above LIBOR. The ACT strongly defended the use of LIBOR as a benchmark rate for use in agreements. We acknowledge that some lenders may have a cost of funds significantly above LIBOR, especially if they are a non-bank lender or a bank without a strong presence in the interbank market for

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the currency concerned. But they must have known that when they undertook the obligation to lend. Lenders presumably have a difficult decision as to whether they want to go public and state they are no longer able to fund at LIBOR, with all the negative publicity associated with that and their knowledge that corporates have long memories. The market disruption clause, if triggered by the required 30% to 50% of lenders, normally acts so that all lenders move to cost of funds, which may well be unpalatable to other syndicate members not wanting to disclose funding costs, and especially to those that in reality fund at LIBID, who will find their return reduced.

Lenders are key stakeholders in a company, so it is sensible for the parties to maintain a constructive relationship between themselves. It was in this spirit that the ACT's advice to borrowers, should they hear that lenders were having difficulty on matching LIBOR funding costs, was to consider whether moving to a very short-term interest re-set period would help, since, on the back of central bank operational liquidity provision, funding rates here were more likely to be consistent with LIBOR – and LIBOR rates may themselves be lower, given the steepness of the short-term yield curve, a double saving for the borrower. In testing the market disruption clause we have learnt that it is not a straightforward protection for lenders, who may encounter competition law dangers in disclosing funding costs to each other. For borrowers the lesson is to tighten up the definition of the "reasonably" selected cost of funds and the proof required from lenders to support any claim.

Borrowers may want to exclude non-banks from counting towards the required threshold for calling market disruption.

While there is no credit rating in the definition of LIBOR, many textbooks said in the past that it was generally accepted as the rate at which AA banks received responses to invitations to quote. Major banks would normally be expected to fund, at the margin, at their bid, rather than at the solicited offer, in any case. Lesser banks accepted, in coming into a loan, that their marginal cost of funds would probably be greater than major banks' bid, and so the profitability of the transaction to them would be smaller and their risk higher.

In documenting a new deal, borrowers may seek a stipulation that any participant must warrant that they normally access funding at or below LIBOR. On the other hand, lenders may be putting on pressure to move to use a panel of banks in the first instance. Rather than include just the larger players, who probably already contribute to the LIBOR panels, they will be wanting to include smaller ones to push up the funding rate.

At this stage in the debate we start to wonder about the fundamental nature of the loan market itself. If the lenders, be they non-bank or minor banks, are of a lower credit standing than the borrower and there is a risk of market disruption provisions being invoked, then what was the point of including those lenders in the syndicate? Far better for the borrower to disintermediate them and raise its funding direct from the capital markets in its own name.

Borrowers are going to want a lot of persuading to allow any transfer of the obligation to lend away from the banks first chosen. Should we re-invent the non tradable loan? It would make these questions and the tax a lot simpler.

If the lenders, be they non-bank or minor banks, are of a lower credit standing than the borrower and there is a risk of market disruption provisions being invoked, then what was the point of including those lenders in the syndicate?

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The outlook

Borrowers are well aware that the capital base of the banking industry is much reduced. The likelihood is that lenders will be taking a more conservative view on credit risk. Definitely this will manifest itself in reduced lending capacity. For weaker borrowers, consequently, funding may not be available at all.

Putting together the confidential 'certain funding' needed for acquisition financing will also be more difficult and borrowers will have to show a greater commitment to a faster take-out into longer term bond financing. More issuers will need a credit rating so banks can see that earlier take-out using capital markets seems feasible.

Commitments will be harder to get. They will have more uncertainty prior to signing, with greater tendency for the use of market disruption to avoid completion/adjust pricing. All a bigger issue for leveraged issuers – Basel II makes them not just more expensive for banks to hold, but banks will need also to ration capital. In the years ahead bank finance will be less likely to provide long-term finance for leveraged firms and private equity/hedge funds will face much lower leverage or need to access investors directly.

A new financing paradigm

Even if bank capacity is strained in years to come it is not all bad news. There do exist alternative sources of funding. Even now, capacity is building up within the institutional investors who are making plans for some novel moves. We firmly believe that banks will lose out to new players through disintermediation, but this will be for drawn funding. The banks will still play an essential role in their unique product of undrawn, stand-by financing, with the structures designed to discourage usage. The Nestlé facility announced this autumn is a good case in point, with an ultra low commitment fee and a margin based on 40% of the CDS margin, with a collar.

All this prompts the question; what are banks for? Traditionally they act as delegated monitors of credit and provide maturity transformation. The skill of a banker is to reach a view on credit, provide set pricing and thereby give certainty of funding and of costs to businesses. If banks have no confidence in their own abilities and instead fall back on variable pricing related to CDS margins, with get outs for the least cause, they lose their USP (Unique Selling Proposition) and much of their raison d'être. Certainly I would expect strong resistance to the use of CDS based pricing except in special circumstances. CDS spreads are notoriously volatile and more related to trading activity than the underlying probability of default/loss given default. Overarching these concerns, and far more important, is the public policy impact of creating a form of loan pricing that is pro-cyclical, capable of pushing troubled companies into deeper financial difficulties at just the time when it could be fatal. This is exactly what central banks are wanting to avoid. The credit-crisis has amply demonstrated within the financial sector the dangers of entering into vicious downward spirals driven by unintended consequences of apparently unrelated actions, policies, regulations or agreements.

If it is considered appropriate to share risk between borrower and lender with some form of pricing grid, it may be better to use references, such as specified financial ratios, which are more reliably determined and around which the borrower can perform proper business planning rather than falling prey to the vagaries of pricing in the CDS market.

Have not covenant light loans created in the bull days of 2007 demonstrated the public policy benefits of not getting trapped in a round of defaults which could have finished off many highly leveraged companies? Through the extra leeway granted to such companies, some will survive the downturn that might otherwise have fallen foul of hair trigger covenants and conditions, although for some their eventual failure may be all the more serious.

Conclusion

The current financial crisis has demonstrated that banks have a critical role in facilitating economic activity. For that reason, they have attracted governmental support. The banks will need to remember that they do in return have wider social corporate responsibilities.

Personally, I expect that the market for investment grade clients will come back much more quickly than most seem to feel. Perhaps 18 months will see much more normal conditions for bank client leverage, although transactions may show different features.

Many corporates have very long memories and treasurers do talk to each other – so banks need to reflect on that. Equally, when negotiating the next round of stand-by lines, banks will remember which (very few) corporates were drawing low-cost loans for arbitrage purposes. ■

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