

# The long tail



THE BANK LENDING MARKET IS SLOWLY RETURNING TO NORMAL AFTER ITS COLLAPSE, BUT LENDING ACTIVITY IS STILL LIVING WITH THE CONSEQUENCES OF THE CREDIT CRISIS, AS **WILL SPINNEY** DISCOVERED AT A NORTH WEST REGIONAL CONFERENCE IN MANCHESTER.

**A**n ACT North West regional meeting in September considered some topics especially relevant for the medium-size corporate and the FTSE 250 market. The three main issues were: the availability of finance and its cost, the implications around credit risk in derivatives and other exposures, and bank relationships.

**AVAILABILITY OF FINANCE** There is some evidence of improvement in the banking sector, with normality returning to the market following its collapse during the credit crisis. Lending terms are shifting back towards normal, with more five-year deals being done and the documentation was also relaxing a little back to what might be considered normal. Back in April the ACT annual conference heard that the private placement market was active and that deal sizes were coming down, making it more suitable for the smaller firms. The meeting also heard evidence that margins were falling and that some banks were chasing transactions to ensure that their capital was lent and earning above cash returns.

There was a lot of discussion at the regional conference about the implications of possible future regulation of banks. Joint controls on both liquidity and capital would have consequences for the pricing of loans, and firms can be expected to pay more for borrowing as more liquidity is held against repayment of deposits and more capital is held against loan losses. One significant implication is that revolving credit facilities could become very expensive as banks would have to

hold both high liquidity and capital to support such loans.

Despite the crisis, some firms have raised money at some of the lowest rates in a generation through the bond markets, where there has been substantial liquidity; the equity markets were also generally supportive of companies. There is also the risk that governments, as major borrowers, might crowd out the private sector. Trade finance has become generally more important and is one area where banks are keen to help firms. The government initiative on non-bank finance should help, as should the London Stock Exchange push into the retail bond market. However, it should be remembered that non-bank finance has been available in the term structures of bank deals for several years, most notably in leveraged transactions.

The issue of cost of finance as against its availability was raised. The point was made that no treasurer wanted to tell the chief executive that the cost of finance was going up, but that telling the CEO that no money at all was available (for that deal of a lifetime) would be an even more career-limiting response.

**CREDIT RISK** Turning to the issue around credit risk in derivatives, some conference attendees noted that they had been asked to post collateral against derivative positions, in one case when a floating charge was already in place with the particular counterparty.

The issue was summarised in that the risk might arise from either the underlying price movements in a derivative causing a repricing or



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replacement risk and then the settlement risk on maturity. The issue extends to derivatives including options, forwards and swaps as well as letters of credit and bank guarantees. It was demonstrated that settlement limits such as BACS or even daylight overdrafts might also be treated as requiring collateral.

There was still uncertainty about the new capital rules, as banks will have to consider the capital usage in derivative or settlement facilities and how to recoup that cost. The meeting heard that one bank had offered the possibility of a cash sum up front in place of having to post collateral. The possibility of enforcement in this area was now more remote, with both the US and European approach targeted at the larger users. It will therefore become an issue between corporates and their banks, with the issue centring on cashflow volatility where collateral placing on hedges had a different timing to the underlying cashflow.

Given the combination of lack of availability and margin calls, there was a feeling that corporates should aim to have cash on their balance sheets and fund early. Using fewer banks might reduce the issue from a portfolio effect and might also make administration easier as the counterparties would know each other better. Collateralisation could be in their best interest of those corporates concerned about the credit risk of their bank counterparties.

**BANK RELATIONSHIPS** The final subject was bank relationships. The traditional dimension of the transaction vs relationship approach was described and the evidence from April's ACT annual conference was that the relationship approach was generally adopted by treasurers and had been effective during the credit crisis. Another implication of the relationship approach is that banks require ancillary business as a condition of lending, and varying degrees of compulsion were put forward as examples of this. It was generally seen that lending has been a loss leader for banks and that, over time, lending is not a profitable line of business for them.

There was also some evidence that banks are resorting to a transactional approach, the main evidence for this being that lending is increasingly fully priced, rather than subsidised by ancillary business. While this is to be generally welcomed, as it lets treasurers know what price services really cost, there is a risk that the relationship between corporate and bank could be misunderstood by each side. The meeting strongly recommended a full and frank discussion between bank and corporate of the approach of each side to avoid such misunderstandings. One area that some companies were tackling was to assess the cost to them of bank services such as derivatives and cash management and to score the banks accordingly.

Other issues that emerged at the meeting concerned how many banks to have, both for lending requirements and for cash management. If bank counterparty credit risk is an issue, then concentrating cash management in a few banks could be dangerous. However, too many cash management banks makes for complexity, so a balance needs to be struck. Care needs to be taken as to which type of bank to have. Suitable differentiators include those with a big balance sheet, those with a big geographical footprint, or those with good systems.

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