3.5.2 Making Yourself a Good Borrower

Self-Test Questions

Unit: Unit 1 – Treasury Strategy

Module: Module 3 – Financial strategy

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Summary: Questions around bank relationships and relationships with other lenders and rating agencies.

Keywords: cash cover ratios, syndicated loan, Basel II, Basel III, derivatives, origination capacity, guarantees (cross/upstream/downstream), credit protection, bilateral, pari passu, going concern, gone concern, ring fencing, covenants, warranties, events of default, Solvency II, rating agency

Question 1

Why are cash cover ratios, rather than balance sheet and income statement ratios used by lenders to monitor highly leveraged structures? How might this affect the financial management of the borrower?

Question 2

Your company, which has been through troubled times and is showing signs of recovery, is considering refinancing a GBP 750m syndicated loan.

The bank which led the last syndication, done on a “transaction” basis because your relationship banks were unenthusiastic, is not currently (nor has been) a “relationship” bank, except to the extent of its current lending.

The proposed new banking grouping to form the syndicate is all relationship banks. The probable lead bank in the group feels that the previous lead bank should be in the new syndicate as much for appearance’s sake as well as for various practical reasons.

However, the previous lead bank wants a higher return since it is not a “relationship” bank to the group and thus is not a beneficiary of ancillary business.

Two other banks which already lend to the company in the current syndicate at rates higher than the proposed refinancing are aggrieved at the potential loss in income.

A further bank has reservations about financing business in a particular geographic region which is significant for the company’s future growth.
However, within the new syndicate all banks must be treated equally.

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Required:

a) Which route (syndication or bilaterals) would you pick for the refinancing and why?
b) During the previous syndication you were aware of occasional frictions between the leader and individual syndicate members, although you were never sure about causes. You also felt that the arrangement fee, negotiated higher during the syndication process, was excessive. What in your view should be the role of a syndicate leader?
c) Suggest a rationale for justifying the size of the arrangement fee which will be negotiated with the syndicate leader and for dealing with the disquiet of the previous lead bank and the other dissenting banks about remuneration.

Question 3

Basel II is the current international rule book governing bank capital adequacy and will be replaced by Basel III in the near future. Under these regimes, banks are required to assess and model corporate credit risk in a very quantitative and transparent way so that the regulatory authorities can assess banks' capital adequacy requirement more precisely. This results in a steep credit quality pricing gradient so that, for example, sub investment grade borrowers must pay significantly more than investment grade borrowers. It is likely that the cost of both liquidity and derivatives will rise significantly.

The impact on loan pricing has been that investment grade borrowers around A/BBB have not been heavily affected but for credits below BBB (sub-investment grade) higher pricing has been introduced which more accurately reflects the credit risk. In addition, however, and perhaps more importantly, banks have become less enthusiastic to lend because of the now more transparent and objective impact on portfolio quality. Derivatives have started to become more expensive for all borrowers for similar reasons, but especially those below BBB.

You are BB- and refinancing a EUR900m syndicated loan. The syndicate banks are unwilling to provide more than EUR450m because of portfolio considerations. However, they offer to introduce you to non-bank institutions that are willing to accept sub-investment grade loan risk but have no origination capacity themselves and therefore no resources to canvass for business directly with individual corporates.

Required:

What are the likely implications for the corporate of using non-bank institutional funding?

Question 4

What are the two ways by which a bank seeks return of loaned funds? Which is more important?

Question 5

Why might tax planning arrangements not be helpful to lenders, seeking them often to require cross / upstream / downstream guarantees for lending?

Question 6

If a group of companies has both weak and strong subsidiaries, how might one structure creditworthy lending (for lenders) and otherwise inaccessible borrowing (for borrowers)?

Question 7
What are the major principles of credit protection taken by lenders, following on from a borrower's need for long term funds?

Question 8
How do banks differ from other lenders to corporations?

Question 9
What is the role of rating agencies in making yourself a good borrower?

Answers

Answer 1

Cash flows are possibly closer to a real measure of the company whereas accounting profits and balance sheet values can be manipulated. Also, much more is at stake and, initially at least, both interest and loan repayments have to be met from internally-generated cash flows - no refinancing is allowed. This is an example of how management of a firm is affected by its financing. In a normally financed firm, financial strategy is concerned heavily with leverage which is traditionally based around accounting metrics such as loan to value, e.g. percentage of assets financed by debt or net debt to EBITDA. But in a highly leveraged structure, cash generation is absolutely key and lenders want to see more cash generated each year than debt is serviced, so that debt falls on a year by year basis. Management are therefore motivated to achieve the covenant. They will therefore manage cash conversion from trading, working capital and especially capital expenditure to ensure that they stay inside the covenant.

Answer 2

a) Which route for the next refinance?

If the company is in any way tainted as this one appears to be, a syndicated approach is almost certain to be the correct route to follow. Negotiating a set of bilaterals is likely to be too complex, given the variety of different terms likely to be required, and because of difficulties in ensuring all are pari passu - especially if security is required. Within a syndicate, the more supportive banks may be in a position to moderate the attitude of the more aggressive ones (although this is not a given).

A group of banks will give the necessary capacity for a refinance. Bilateral loans would all have to be available at the same time for a general refinancing and this is more complex to organise than a syndication. Also, at the time that the old syndicated loan is switched into the new bilaterals, the initial bilateral drawdown potentially doubles up the exposure for a bank which is both in the old syndicate and in the new group of bilaterals. Such a bank would not wish to take the extra refinancing risk of other banks outside a syndicate structure [even if only on an intraday basis].

b) Role of syndicate leader

A syndicate leader is not really a defined role although one may be appointed, probably for a smallish fee, or one may emerge from early negotiations. A bank with stature is the best candidate for this role, one that most banks will respect for its leadership and decision making experience. For example many banks will follow such a bank into a deal merely because that bank is in the deal. Typically the syndicate leader is normally expected also to have a larger commitment in the facility. By nature of the role, the syndicate leader should have a deep and broad relationship with the borrower; sufficient to facilitate effective communication between the syndicate group and the borrower, putting each side's views across fairly.

The use of such a leader can vary from having all communication channelled through the leader or merely administrative communication. Usually the leader will manage the legal process of documentation, instructing lawyers and carrying out the negotiation with the

borrower on behalf of the syndicate. However a realistic structure with pricing and main terms (set out in the term sheet) does need to be present before this can happen.

The leader is best used to obtain market levels for pricing and other factors and for helping to bring dissenting banks into line as those banks will listen to the leader rather than the borrower.

c) Rationale for arrangement fee

The leader may be more interested in showing off their role as leader than actually earning a fee for their services and therefore a fee might be a round sum rather than a percentage of the loan amount.

However if the leader really does take on a larger lending role than other banks then a higher fee will be generated by the percentage of its commitment.

The major problem with a dissenting bank is that all banks must be treated pari passu in a syndicate and so any bank wielding its power for higher fees must either be excluded or either the fees raised generally or loan conditions made stricter to meet the most expensive bank's minimum expectations (so-called 'market flex' provisions). It might be possible to pay the dissenter an inflated fee outside the deal for other services but there is always a danger that this will be discovered by other banks and disapproved of, causing friction among them.

The key thing is that syndicates are very sensitive and members do not like being treated differently from others in any way at all.

Answer 3

The main implications for corporates borrowing from non-banks are:

- Borrowing capacity can increase hugely as these investors have different return criteria, as they have no capital adequacy requirement.
- Certain minimum margin requirements may however be non-negotiable.
- No ancillary business is normally required.
- Fund investors are difficult to approach so amendments to the terms of an issue may be difficult (some funds will only react to a request if they are paid). If all are lending against the same document, a feasible approach would be to the get commercial banks to agree amendments and then force through the other institutions. This approach is obviously not without risk.
- Loyalty of lending is not offered and transfers by non-bank investors will normally be unrestricted, and outside the control of the borrower.
- Confidential information may (will) end up being passed to these funds - they become "insiders". They may decline to see it but confusion can be caused about who knows what and what can or cannot be discussed.

The implied arrangement fee is highly profitable for banks who usually keep it all.

Answer 4
The classic ‘two ways out’ are Going Concern and Gone Concern. Both are important but modern lending is possibly more focused on going concern (continuing cash flow) than gone concern (asset disposals). However, in seeking protection of its position, the bank will ensure that has access to all the assets ensuring a “Gone” recovery that is as strong as possible.

Answer 5
The method by which funds are passed down to subsidiaries can have a radical difference on recovery in insolvency. Funds lent to the parent which are passed on as equity in subsidiaries is particularly at risk because a lender is then behind other creditors (‘structurally subordinated’) in a recovery. Guarantees push the lender back up the queue and security can push them even higher up.

Answer 6
A strong subsidiary can be ring fenced, so that it is not infected by the rest of the group and its cash generation is not sucked into loss making projects.

Answer 7
The basic principles are that:

- No lender must become more senior than them.
- Credit deterioration is to be avoided.
- Action must be possible to recover the loan if credit deterioration occurs.
- Control is needed over certain corporate events

This leads to covenants, warranties and events of default.

Answer 8
Whereas non-bank lenders simply look for a return commensurate with the lending risk, with adequate levels of security, banks need to make a return on capital and judge this over all products offered to their customers. In addition banks are heavily regulated, limiting their risks and returns, whereas mutual funds and investment trusts have more flexible criteria. Thus bank loans (where they compete with other non bank lenders) must be subsidised by other business, which they therefore need to seek aggressively. This is called ancillary business.

Note that non-bank lenders are in some cases regulated by Solvency II.

Answer 9
Firstly rating agencies are effectively sellers of credit quality. If a treasurer can be seen as the salesman for credit risk by a firm, and does this mostly to banks, then the rating agency effectively does this for non-banks (and some banks) because the agency publishes reports on the credit status of borrowers and many potential lenders use this as the only source of credit risk assessment. Therefore, apart from road shows, the rating agency is effectively a conduit into non-bank lenders (and some banks). Even banks that do their own credit assessments use ratings as an important check of their own work.

Secondly targeting a rating is a common element of financial strategy and the discipline required to maintain the ratios and credit quality forces a borrower to be as high quality as it can. This extends to the disciplines of:

- Management attention to meetings
- Modelling skills
- Forecasting accuracy
- Matching credit quality to liquidity (by monitoring markets)