

Capital Markets Bulletin

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A series of occasional papers from our Capital Markets Sector Team on matters of interest to a wide range of market participants.

Thematic review of firms' dealings with corporate restructurings

In our feedback statement on Private Equity, FS07/3¹, we recognised the risk of leverage in individual transactions increasing to excessive levels, making the financial viability of the underlying corporate firm unsustainable. We commented that this makes the default of a large private-equity-backed company seem inevitable. We also noted the risks that the growth in credit derivatives may pose to corporate workouts. Consequently we conducted a visit program to assess the impact that large corporate failures may have on the quality of the market place as a whole. Our focus was not towards the merits or otherwise of 'saving' an individual firm in distress. We carried out this review because of the significant changes in recent years within the corporate credit markets. These include:

- the investor base for loan and debt instruments;
- the range and complexity of debt structures that have been originated; and
- the appetite that banks and other, less traditional, investors have for engaging in the corporate workout process.

This note reports on our findings from a review we carried out during 2007.

Our interest in corporate restructuring

One of our four statutory objectives is maintaining market confidence. The secondary market for distressed loans and debt plays a key role in the pricing of recovery prospects for distressed firms. This allows investors with alternative views on the value of a firm's debt securities to increase or decrease their exposures to firms including distressed firms. Market confidence partly depends on the fair, orderly and efficient markets for distressed securities and the ability of investors to access relevant information on the financial condition of the distressed firm. So in this paper we examine the factors that can affect market confidence in this area.

Scope of review

We carried out this review in 2007 to assess the appetite of regulated firms to actively engage in corporate workouts. We also examined how well firms are resourced to meet a significant rise in corporate defaults, and the potential consequences for the markets of recent changes in the corporate workout landscape. Our work was prompted by an earlier initiative that examined banks' exposures to the leveraged loan market. These exposures had become more concentrated and the debt/EBITDA multiple had increased.² We did not consider changes in, or potential changes to, the insolvency regime – this is outside of our statutory powers.³ This paper draws on visits to asset recovery teams at banks, loan and debt investors; trade associations that represent issuers; trade associations that represent banks' loan origination and trading operations; and insolvency practitioners.

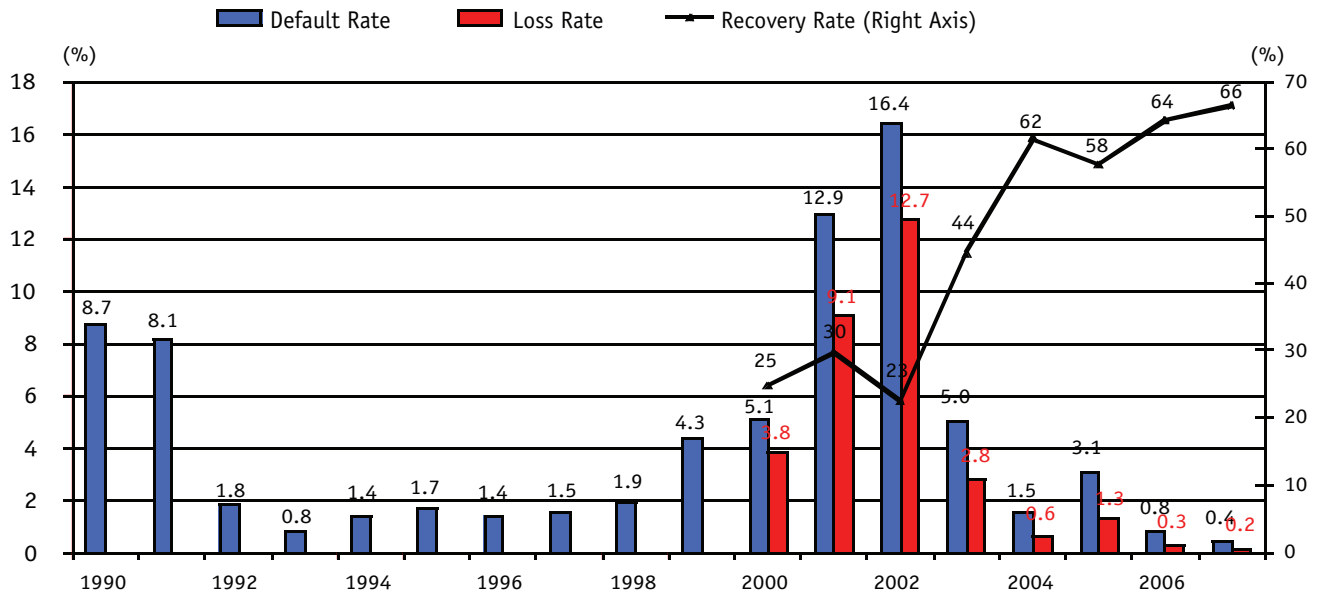
1 Private equity: a discussion of risk and regulatory engagement (2007), www.fsa.gov.uk/pubs/discussion/fs07_03.pdf

2 Financial Risk Outlook 2007, Leveraged finance www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2007.pdf

3 Enterprise Act 2002, Evaluation Report 2008, www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/EA02CorporateInsolvencyReport.pdf

Changing market structures and participants

It has been widely noted that the rate of corporate defaults has been at historically low levels since retreating from the rates seen in 2001 and 2002. Default rates are expected to rise further in the coming months. This is foreshadowed by widening credit spreads, a tightening of credit lending standards by banks and the reduced risk tolerance and de-leveraging of positions held by investors.



Source Bloomberg and Fitch Ratings

The corporate restructuring landscape has significantly altered since the last peak in default rates in 2001 and 2002. There have been several notable changes:

- an increase in the activity, range and complexity of debt, loan securities and derivative instruments outstanding;
- a shift in the issuance of primary debt by banks, who now operate an ‘originate-to-distribute’ business model;
- a shift in the way banks manage their exposure to corporate debt with credit risk transfer products; and
- a wider spectrum of investor participation across firms’ capital structures e.g. hedge funds, distressed debt funds, CDO and CLO vehicles.

All these changes suggest that future corporate restructuring negotiations will be more complex than in previous economic downturns.

Changes to the restructuring landscape since 2000

Structural changes to the institutional participants involved with workouts

1. Greater turnover among creditors

Greater turnover in the secondary market for distressed debt and loans has been aided by the growth in funds that make investments and implement relative value trades across all sections of the capital structure of a firm. An active secondary market allows debtors who do not want to take part in a restructuring to sell their distressed bonds or loans. It is also essential for investment vehicles that are permitted to hold debt rated below that specified in their investment mandate and are required to exit their positions. Additionally, credit derivatives provide another means for investors to take positions or hedge their existing exposures.

So the secondary market in distressed debt may bring knowledgeable participants with considerable restructuring skills to the negotiating table, while allowing those investors who do not want to remain invested, or commit further capital in a restructuring, to sell their holdings. This may drive greater similarity in the investor base of distressed companies.

However, it goes without saying that investors buying distressed debt during the restructuring phase will pay significantly less than original par investors. Those investors buying into distressed companies will have different investment horizons and return expectations than earlier investors who have retained their exposure. In such cases, the creditor base may have very different motives and expectations, creating a more-complex array of interests to be negotiated before a consensus is reached. Regardless of the state of liquidity in the secondary market, the impact of investor apathy should not be underestimated. There are many cases where large numbers of small investors choose not to vote. The time-consuming and expensive process of attempting to communicate with a diverse group of holders to obtain a qualifying majority makes it harder for the debtor to survive as a going concern.

2. Former role of the Bank of England

In the past the Bank of England offered a facility to help in restructurings but this role has ceased. The current position of the Bank of England is described in the following extract.⁴

‘For many years, the Bank of England played an informal role in facilitating the resolution of financing crises affecting large UK companies. The Bank was particularly active during periods of economic stress. As time has gone on, however, the channels of financing for such companies have become more diversified and complex, the international dimension has in many cases come to be more important and the climate in terms of litigation (or avoidance of litigation) has become more intrusive. In recent years, for these and other reasons, the Bank’s involvement has declined significantly so that it now no longer holds itself out as providing this facilitation role.’

⁴ Bank of England, Corporate workouts, The London approach
www.bankofengland.co.uk/financialstability/businessandhousehold/corporate_workout.htm

3. Role of INSOL

The International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) has principles⁵ that recommend creditors should reach, during a ‘standstill’ period, an informed consensus on the future of distressed firms. This is best achieved by creditors coordinating their response, appointing advisers, and sharing information on the debtors position on a confidential basis. These principles embody much of what was formerly termed ‘The London Approach’. The principles mark ‘the high-water level of the bank-led club style approach to workouts that had characterised the London market in the 1980’s and 1990s’.⁶ The appropriate measure of the principles’ success is whether informed negotiations on the future prospects for a distressed company take place, not if a company is successfully restructured.

Changes to corporate capital structures

4. Added complexity within corporate structures.

Since 2002, during a benign credit environment there have been many corporate structures financed with higher leverage multiples. These structures often came with a high proportion of senior debt but with thinner subordinate layers of junior, mezzanine and equity capital. In the event of financial distress, the non-senior debt holders will have little or no value ascribed to their claims. Nonetheless, wherever the value breaks in the structure, the money claimants who have nothing to lose may hotly contest the value ascribed to their holding, and any proposals they are required to give consent on. Senior debt holders may prefer to sell out rather than remain within a contested workout. On average, the recovery rates may be lower for the senior debt holders in structures with lesser amounts of subordinated capital.

At the same time, many debt issues were placed with weaker covenants. Creditors will not be able to begin the negotiations over a breach of covenant, nor exercise any control over the firm, until a covenant is breached. By the time a creditor’s covenant is triggered, the firm will be more deeply in distress than if measures had been taken sooner. A restructuring may no longer be a viable option or will be more costly and resource intensive.

The challenges for institutions in managing a workout

5. Reduced leadership

Previously, banks with the largest exposure or with the closest relationship to a debtor would have a natural interest in taking the lead in restructuring negotiations. The advent of the ‘originate to distribute’ banking model and the growth of alternative lenders⁷ means that many banks have withdrawn from their traditional role as relationship banker. Instead banks will now sell their position on origination, or shortly after, into the secondary market.

The leadership role in restructurings serves to ‘scoop-up’ all relevant information, act for the collective good and provide certainty about the state of dialogue. A great deal of information is required by creditors from the debtor, including the debtor’s cash position, sales forecasts, debt sustainability and cash flow forecasts. In the absence of any party stepping in to fulfil this important role, coordinated dialogue between creditors and the debtor will be poorer. In some cases, banks will still have an incentive to steer creditor committees such as when the bank has close relationships with other major creditors of a distressed firm. Overall, we may expect some creditor discussions to be less organised and more difficult to drive forward.

5 INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts (2000) www.insol.org/pdf/Lenders.pdf

6 Leadership Retreat, INSOL World – Silver Jubilee Edition 2007.

7 Non-bank financial institutions comprised 7% of the European leveraged loan market in 2000, but 40% by 2005. In the US, primary market leveraged loan purchases by non banks comprised 29% in 1994, but had grown to 78% by 2004.

The inappropriate use of material non-public information (MNPI) represents a significant risk to market confidence. The significant expansion in secondary trading of credit risk transfer products has increased the opportunity for market abuse.

We are reminding firms that they should adequately control information flows from public and private side sources, particularly if they intend to trade their positions.

Creditors who plan to operate independently of the creditor committee should test their ability to access information on distressed firms.

Some creditors may be able to operate independently of the creditor committee(s) and obtain all the key information they require to evaluate a distressed firm's prospects. It would be prudent for creditors who have had minimal involvement with restructurings to test their assumptions as to whether other parties outside of the creditor committee could, in fact, provide them with their required information.

6. Added complexity – impact of credit derivatives and transfer of economic interests.

We noted that the increasingly widespread use of credit derivatives, (in particular credit default swaps (CDS) and loan default swaps (LCDS)) on restructuring negotiations can create some surprising dynamics within and between creditor committees. The existence of CDS cover on a debtor may affect the interests, motives and behaviour of stakeholders during negotiations. It has been argued that it may be in the interest of the creditors holding protection to trigger the occurrence of a credit event, which would not be in the interest of the other creditors and may fetter a restructuring. However, many holders of credit protection will not have fully covered their position and their protection may have been bought at varying prices. Insolvency practitioners have commented that, so far, there is no evidence that a restructuring has failed solely as the result of creditors CDS holdings.

We recommend that firms carefully consider the mechanics and potential impact of credit derivatives from their perspective. A useful starting point would be INSOL's publication⁸, 'Credit derivatives in restructurings'.

Credit protection sellers (if they have no other exposure to a distressed firm) cannot participate in restructuring negotiations until a credit event has occurred and the underlying debt transferred to the protection seller. The value of outstanding derivative contracts is now often far larger than the stock of underlying reference debt. The cash settlement protocol developed by ISDA utilises an auction process to determine settlement prices for outstanding credit derivatives. This is a positive development for the market⁹ as the optional cash settlement mechanism permits the rapid settlement of most outstanding contracts, when a credit event occurs. However, the physical settlement of credit derivatives may bring a new wave of creditors to the restructuring committees, some time after the credit event with attendant complications of coordinating communication among creditors.

Silent sub-participation is the process where an existing lender of record transfers repayment rights relating to the debt to a third party but continues as the lender of record without the knowledge of the borrower. It means some of the parties involved in the restructuring negotiations may not actually have any net economic exposure to the company. Only the lender of record may negotiate for the silent sub-participation holder at the creditor committee; the committee is not told about the existence of the sub-participation agreement. The lender of record needs to consider what rights it may wish to reserve within a silent sub-participation transfer agreement, to prevent the silent sub-participation buyer demanding votes be cast in a way that will harm the reputation of the sub-participation seller.

⁸ Credit derivatives in restructurings, INSOL (2006) www.insol.org/pdf/credit_derivatives.pdf

⁹ See ISDA Protocols www.isda.org for the application of optional cash settlement protocols, which are still evolving.

7. Creditors – counterparty risk management

Firms' management information systems should be geared to producing timely identification and monitoring of counterparty exposures. The ability to aggregate direct and indirect exposures regionally, globally and across entity and product lines is central to effective management of counterparty risk.¹⁰ In the firms we saw, monitoring of corporate exposures, both drawn and undrawn, is undertaken by daily reports prepared for the relationship management staff. Some firms also made regular independent checks by the credit department and/or asset recovery team of corporate exposures.

8. Asset recovery teams and exposure risk management within banks

Early alert processes for looming problem credits increases management oversight within creditor banks by placing deteriorating credits on a watch list and triggering senior management involvement. We noted that, typically, all distressed credits, except those held by proprietary desks, are passed to the asset recovery team for resolution. The asset recovery teams did not have access to the exposures and trading decisions taken by their proprietary desks. Information walls were in place to prevent information from the asset recovery team flowing to the trading desks.

Asset recovery teams decide how to manage their exposure and represent the bank during restructuring negotiations. The teams were structured to work closely with credit departments and relationship management staff by passing back all benefits received on a successful workout, less any costs of the recovery team, to the loan book.

We observed a considerable range in the scale of resources committed to in-house asset recovery teams. The wide variation in practice reflected the differing business models of firms and the firms' appetite to remain invested throughout the workout processes. However, the speed with which resources may be brought to bear on restructuring negotiations may influence the recovery prospects. A speedy agreement of the restructuring plan will preserve the going concern value of a firm.

Firms with large asset recovery teams appeared more committed to remain as a lender for relationship reasons throughout a work-out process. The decision on whether to use the secondary market to exit positions is based on many factors: the level of firms' exposure; expected probability and rate of recovery; the expected complexity of the workout; and the market price of distressed debt.

Firms with small recovery teams relative to the size of their business had contingency plans to take additional staff from their credit teams and hire externally should default rates rise. It remains to be seen how quickly such a transition in staff levels may be effected.

The complexity of future workouts may prove greater than some firms are anticipating. We are asking regulated firms to assess whether their current and planned resources for dealing with corporate workouts, on a timely basis, are adequate.

We found that firms with small recovery teams were placing greater reliance on their ability to identify problem credits early and then exit their positions in the secondary markets. The wisdom of such a strategy, which relies on a firm's early detection ability being superior to that of other market participants and the liquidity of secondary markets remaining constant, is open to question. Recent events have again demonstrated that secondary market liquidity cannot be relied on during times of market stress. While firms may eventually exit or hedge their positions, it may not be at the price sellers first anticipated. And hedged positions leave firms exposed to basis risk.

¹⁰ Toward greater financial stability: A private sector perspective, Counterparty Risk Management Group II, 'CRMPG II' (July 2005) www.crmpolicygroup.org

We are asking banks to consider whether their exposure management plans place undue reliance on a liquid secondary market.

9. Debtors – resources and information challenges

When restructuring negotiations begin, borrowers will be faced with considerable demands for information on the prospects of the firm, particularly forecast cash flow. The backward-looking nature of profit and loss statements is of little interest to creditors. Borrowers will need to place more emphasis on delivering forward-looking cash flow, inventory management and budget information and responding to ad-hoc information demands from creditors.

Debt issuers can bring greater certainty of their information obligations to investors by creating two separate information covenants when debt is issued by the firm. These covenants distinguish the information obligations of the issuer, separating those due on origination from those due over the life of the loan.

Issuers and advisory firms may, in future, play a more active role in restructuring, especially where banks have been replaced by non-bank institutions. Naturally, staff with prior restructuring experience will add the greatest value in a workout. Given the limited number of large corporations which have been restructured in the last few years, such skills are likely to be in short supply.

Conclusions

It is unclear what impact the increased diversity of investors in corporate debt will have on achieving a timely and orderly workout. Each workout may depend on its particular facts and circumstances of a firm's capital structure, covenants and ultimate investors.

- It would be prudent for all regulated firms who participate in corporate restructurings to consider whether they have adequate resources to manage multiple protracted and complex negotiations.
- We are reminding banks to consider the implications of relying on risk exposure management plans which place undue reliance on a liquid secondary market to reduce exposures.
- We recommend that firms carefully consider the mechanics and potential impact of credit derivatives from their perspective. A useful starting point would be INSOL's publication¹¹, 'Credit derivatives in restructurings'.
- Creditors who plan to operate independently of the creditor committee should test their ability to access information on distressed firms.
- We are reminding all parties that they should adequately control the information flows from public and private side sources, particularly if they intend to trade their positions.

11 Credit derivatives in restructurings, INSOL (2006) www.insol.org/pdf/credit_derivatives.pdf