Corporate Debt Restructuring from a Lending Bank’s Perspective

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ABSTRACT

This research paper is to enlighten readers on how a lending bank views a workout, and what exactly makes banks tick in these invariably testing circumstances. What is it that distressed borrowers can do to give themselves the best chance of winning the bank’s continued financial support and therefore giving themselves their best chance of saving their own esteem? What is it that the banks expect of distressed borrowers? Why do banks take certain actions? It is really this final point, why do banks take certain actions in workouts that this paper will focus on. There are a number of myths and misconceptions about the behavior of banks in workouts among professionals such as accountants and lawyers as well as corporate managers. It is the best interests that this paper tries to clarify these behavioral points as far as possible. This paper will take the opportunity to make clear to a large number of readers just how a lender think and operate.

INTRODUCTION

The term “workout” can be defined as the non-statutory agreement by lending banks to extend financial support to a company, which, without this support, would have to cease trading. The whole point of a workout is to create a stable environment that enables bankers to support troubled companies whose problems are generally thought to be curable over a period of time. It is vitally important for lenders to understand each other’s thinking process, as progress is generally made in workouts only where the bankers, lawyers and accountants come together, and move in a common direction. With growing levels of workout experience and broadening of that knowledge base, there is now a commonly accepted framework for organizing workouts. This framework lessens the need for lenders to revert to insolvency litigation. Unfortunately this paper has to add one caveat to our efforts in explaining how banks think and act. There are a relatively number of banks will ever be able to fully comprehend their ways of thinking. These banks have sometimes acted as hot-heads, irrationally, and given anything but to support distressed borrowers particularly in difficult economic times.

A lending bank which is asked to provide continued financial support will make that support conditional upon the borrower providing full cooperation, communication and transparency. A borrower who chooses to act otherwise may get away with their tactics, but the banks can easily see through this. The banks may appear to be turning a blind eye but it is more the fact that banks recognize desperate men often do desperate things and that time, patience and rational decision making should produce the best returns to all. The bank’s patient is finite and a company will eventually fail if they choose not to be cooperative, communicative and transparent. In other words, when its apparent agreement will never be reached, regardless the level of potential return the banks may be foregoing. In that case, both the borrowers and the banks are losers. If borrowers cooperate and provide full access to information, banks will in turn be reasonable in their expectations as regards debt restructuring and ultimate levels of
recovery. To support the same arguments, readers have seen in the press that bank groups have kept companies alive by accepting returns as low as 5 cents in the dollar and sometimes with a fairly meaningless debt/equity conversion added on. This can only be achieved where banks have been given adequate information to satisfy that this was the best the borrower and any investor could reasonably offer.

THE BACKGROUND OF WORKOUT ACTIVITY

What is the background to all this workout activity? An unprecedented number of businesses, of all sizes, are today looking to their lenders for a lifeline to enable them to survive. On that basis, it is apparent that banks are handling hundreds and thousands of distressed debt situations all over the world. Despite some recent improvements in market sentiment, that figure is expected to continue rising, albeit at a slower pace. The point in raising this is that companies are and will continue to fail. The hard times are by no means over, and like it or not, they are dependent upon their banks for continued survival.

Some may feel that this level of corporate difficulty was largely caused by a competitive rush by banks in recent time lending too much money on too little information. Companies looking to gear up their balance sheets benefited from the intense competition among banks to lend. Margins became finer and other lending terms less onerous and more flexible. Companies responded by shopping around for the most attractive borrowing terms. That involved a rapid diversification of lending principles, where mutual history and understanding was all but missing. The emphasis was on transactions rather than relationships.

Lenders also took comfort from the presence of security, which in the company's financial crisis, often turn out to be illiquid or, as is the case where business risks are involved, illusory. Banks also had to be over-reliant on security where financial information was not forthcoming. When collateral values then fell, many banks felt they had little choice but to begin withdrawing financial support unless, as has seldom happened, sufficient information was suddenly shared more freely to give them the required comfort. The increased number of lending relationships had created serious problems for borrowers at the first sign of trouble, with banks looking to accelerate loan repayments or withdraw loan facilities.

This in turn created unsustainable liquidity pressures on borrowers, even those with relatively good creditworthiness. This is a particularly acute problem when even listed companies are often tightly held by families and where cultural pressures discourage open discussion of looming problems. It has been extremely difficult for banks to spot trouble coming, the very time when it could have been more easily dealt with, to the benefit of all. It is therefore not uncommon to find that a company in trouble has far too much debt from far too many banks to be manageable as confidence begins to evaporate. Similarly, banks have loan books that have grown rapidly and included exposures to companies they know very little about. Borrowers and lenders were poorly prepared for the downturn (Rouse, 2002).

CORPORATE RECOVERY

Accounts are transferred to corporate recovery as soon as the lending officer becomes aware of some or all of the types of issues just described. The borrower might now agree to the banker’s analysis. The aim of transferring the account is to maximize the protection of the bank against potential loss, by taking advantage of centralized restructuring and recovery expertise. To be effective, this requires swift and decisive action being taken by the lending officers as soon as problems are identified. The corporate recovery manager reviews the lending branch’s files to get a better feel of the key issues. They do not go into any great depth at this preparatory stage. They prefer to keep an open mind and to try and not become
weighted down by any emotional baggage. It is a fact of human nature that the lending officer might be protective of the borrower in the eyes of a third party. At the extreme, communication channels might be severely strained, if not completely closed and all mutual trust lost. They aim to act without emotion and in a purely objective manner. It is essentially a clean start and there is a window of opportunity to repair any damage to the relationship. Time is usually against all of them and that is why they want to meet the borrower on the day they hear there is a problem.

The corporate recovery managers must meet the company’s key decision makers, i.e. board of directors including chairman and chief executive officer. There is no point in them meeting finance or marketing manager. They have no choice but to decline holding the meeting without directors, even if the borrower’s managers are sitting in their offices. Lawyers, accountants and any other advisers are typically excluded at the first meeting as they think it is important for them to initially speak direct with the board. The first meeting with the borrower is absolutely critical. It sets the tone for the whole process and they are looking for the levels of cooperation, communication and transparency. They often have to make on the spot decisions at the meeting to keep the company trading as normally as possible, usually with very limited information. By the end of the first meeting, they will have a broad view of their strategy. This can be one of two available to them, either work to rehabilitate the borrower, or exit the relationship. Rehabilitate or exist, it is as black and white as that. They want the first meeting to be cordial and professional. The corporate recovery managers explain that the account has been transferred to them and that they now have full management responsibility for the relationship. Their original lending officer is no longer involved and all decisions rest with them.

Sometimes their previous lending officer will attend the initial part of the meeting and then leave. This physically demonstrates the change of control and is usually done where they anticipate resistance to the change or where there may be other sensitivities. The corporate recovery managers advise that they deal specifically with companies in some form of distress, usually in the form of cash flow problems, as that covers many situations and is not an inflammatory comment. The recovery managers explain that they handle far fewer accounts than lending officers and therefore have more time available to deal with them. There will not be any excuses from them that they are too busy to meet, even without notice, or to take a call or exchange faxes and e-mails. The recovery managers make it absolutely clear at the outset that the account has not been transferred to them simply they want all their money back. They are not going to thump on the table asking for money. What they want is to understand the situation fully and get themselves in a position where they can all make reasoned and rational decisions on the best way forward. The recovery managers explain that the need to create stability at all levels is the key for both of them.

In particular, the banks will probably need to be stabilized, as some will be hell-bent in getting their debt fully settled. Lender groups are now more diversified and they may need to consider how bondholders can be kept stable, as well as the many customers and suppliers who also have a financial interest in the company’s survival. They remind the borrower that a core part of their business is lending money and that they are always looking for good lending opportunities. Their main aim is to try and make the company healthy again and return the relationship back to the lending officer as soon as they can. Therefore their goal is the same as theirs, to recover from the current difficulties and continue their relationship as before for the longer term. It is essential the directors listen to this point and take it on board. It may be that some or all of their other banks have delivered a very different message. It is not surprising then that their words on how to sort this all out often fall on deaf ears. There is generally great surprise when the recovery managers suggest the whole process could take one or two years.
THE WORKOUT

The workout will involve making some very difficult decisions such as releasing long serving and loyal employees, closing factories, and canceling orders. They emphasize the communication aspect. For all this to work out according to the original plan- any adverse events have to be acted upon jointly as and when they occur. They need to hear both the bad and the good news. Where the corporate recovery managers are not getting their message through, they use the medical analogy. A doctor can only help the patient where they describe their problems as best they can. They remind the borrower their overriding mandate is to protect the bank’s shareholders. They make a point not reminding the directors of their security position, or of their rights to recover debt. This could be viewed as a hostile comment and is contrary to their goal of winning trust and encouraging them to open up. The company is then invited to explain to them what has happened and what the problems are. The main points the recovery managers need to have clarified are simply: 1) The true cash position 2) The reaction of other bank lenders 3) Are trade creditors generally current? 4) Have any threatened or even commenced legal action? 5) Had any key staff left? If things appear totally hopeless, they will ask the board of directors to consider liquidation. They will briefly point out their fiduciary responsibilities as directors, fraudulent trading issues, and so on, and suggest they seek professional legal and accounting advice.

If the borrower does not accept the reality and the recovery managers cannot convince them their case is hopeless, they have to appoint accountants to produce a brief report to persuade the borrower otherwise. Assuming that there is a business worth rescuing, the company will usually end up requesting the bankers to give them time to sort their problems out. The corporate recovery managers recognize directors are, generally, the best people to improve a company’s performance, provided they accept reality. However, the agreement is conditional and must be everyone’s benefit. Although the bank still trusts the borrower to run the business and implement agreed changes, there would be some doubt as to the credibility of the actual and forecast figures they would like to provide. A fair and sensible way forward is for the bankers to ask that an independent third party produces those figures, as well as the options available and recommendations as to the best course to follow.

IS THE BUSINESS VIABLE OR NOT?

In short, lenders must know whether the business is viable or not. If not, can it be made viable? In which case, what needs to be done? A push to viability may involve bankers taking steps that they may not like, for example, interest holidays, principal moratorium, etc. Corporate recovery managers are pragmatic and willing to share pain if that is what is required and in the best interests of both sets of shareholders, namely, preferred and common shareholders. The recovery managers explain the best people to report on this are the accounting firms who have qualified people specializing in this kind of work. These experts will ask the right questions and produce a meaningful report for both borrower and lenders. The accountants are the company’s advisers and are there to help the borrower. Lenders will consider the accountant’s report recommendations and will probably accept the general terms on the basis the best way forward will be recommended. It is therefore the lenders’ request that independent reporting accountants be appointed, to conduct a review of business and submit a report to them within the next 2 to 4 weeks. This inevitably meets with resistance, cost being a major one. Lenders explain the cost represents a very small percentage of the debt owed to them, which they are currently unable to repay as promised.
Without the report, it would now be difficult for the lenders to make well informed decisions as to how they should react. The lenders do not know for sure if it is in their best interests to support the company. As prudent lenders, they would be left with few alternatives but to ask for all their money back immediately. Other objections from the borrower include the comment that they do not need another set of auditors, and the lenders explain this not an audit. CFO can become a bit aggressive at this point, but they will stand on the side of the lenders despite the threat he may be feeling to his own position. In fact, the importance stressed by the lenders of having full financial information made available, shows the importance they attach to this role. Sometimes companies seem to actually relish the debate, even though they intend to eventually agreeing to their request. The borrower feels they have to negotiate everything with the lenders, just as they had always dealt with their banks in the past. The worst case scenario is for the lenders to commence legal action to start the repayment process. The lenders’ requests are put in writing to the borrower, even if they have been already verbally agreed, to prevent any misunderstandings (Rouse, 2002).

Lenders want all parties to know exactly what is expected of them. As potential rescuers of a business, lenders first need to preserve the confidence of suppliers and customers. This means ensuring the company has finance available to continue to trade as normally as possible. Lenders typically withdraw formal limits but cap their credit limits at the current level of outstanding, at least until the accountant’s report is finished. On this basis, lenders no worse off in terms of dollar risk and it allows the company to continue trading. They do not object to borrowers fully drawing down on other banks’ available lines to build up cash reserves while they can. Those lines will inevitably disappear later. Lenders still cannot understand why many other banks react by freezing lines and refusing to revolve at outstanding. They are simply choking the company further by starving it of cash and banking facilities, such as letter of credit issuance. This severely restricts the company’s ability to repay the banks. Lenders should suggest the company that any free cash balances is transferred to a non-lending third party bank, to ensure they are not set-off following any demand for repayment from banks and needlessly lost.

Lenders are careful not to be seen forcing a particular accounting firm on a borrower. They use a standard letter suggesting several names of firms and inviting the borrower to approach some or all of them before making the appointment. They usually review a draft of the mandate to make sure there are not any unacceptable restrictions on their ability to talk freely to the accountants. It is important that they make it clear that the onus for designing the debt restructuring strategy is on the borrower and their advisers. The lenders remind the accountants they are primarily concerned to know whether the business is viable, or what, if anything, can be done to make it viable. They need to know the options available and they want a clear recommendation from the accountants as to the best way forward. The corporate recovery managers make it clear to the borrower that, at this stage, they only want to hear what the accountants have to say. If the borrower asks for temporary facility increases, they will simply refer the request to the accountants and get their input responding. When the final report is received, they meet with the borrower and the accountants to discuss it and hopefully decide on an acceptable strategy. Unfortunately, the report usually reveals that the problems are more deep-seated than first thought. By running through the approach the lenders take at the first meeting with the borrower, and by explaining how they expect to work with reporting accountants, they hope they have given the borrower a feel for the underlying principles they use in workouts.
DO LENDERS ACT DIFFERENTLY IN A MULTI-BANK SITUATION?

Regrettably, most lenders always find themselves to be just one of the many lenders to a distressed company. Even modest sized companies, both in terms of capitalization and turnover, typically have far too many banking relationships. This does not foster loyalty to the company by the banks. CFO many times thinks the greater the number of lending relationships, the less risk the company has in the event of a loss of market confidence. In fact, the opposite is true, a company with, say, 15 to 20 banks is far more exposed to a small number of those banks pulling credit lines and seeking repayment in downturn. They do not want to be the last ones out and they too cancel credit lines and request repayment. Quickly, the company’s overwhelmed with repayment requests that cannot be met under the accelerated terms agreed with the banks which were first to act, or even under the original repayment schedules of those now starting to take action. Syndications and bond issues can complicate the picture significantly. The identity of substantial creditors may never be known following sub-participations and the secondary trading of the bonds. The sheer number of banks the CFO has to deal with will inevitably make him reticent to talk to them. It can be a great task for one person: Does he tell them all the same thing? Should he confide in one more than another? What about all the different advice he is getting along the way? Each bank seems to be telling him something different as regards what to do next. This creates gridlock and in a paralyzed state, nothing gets achieved and the position worsens as the directors become more and more confused as to the best way forward.

On the other hand, a much smaller number of banks, say 3 or 6, is far more than stable when financial problems are disclosed provided this is done early on. There is much less likelihood of a peripheral bank with modest outstanding exiting the relationship in a disorderly manner without regard to the inevitable consequences of their actions. It is also relatively easy for a few banks to meet and thrash out a successful workout plan with the borrower. It is probably fair to say that they do not always consider this to be the case where there are many lenders because in this scenario there cannot logically be a core bank. Regardless, companies tend to pile their problems up on their major banker. Peripheral banks will be getting paid out at the expense of major lenders. Past dues start to appear in their books as cash flows are diverted to make these payments and a workout will follow. If caught in the early stages, by the company telling lenders or they somehow find out before real damage is done, they can get accountants in early to determine whether or not payment of a number of banks is in fact a good thing. If it is, and the business is viable, they will simply monitor cash flows carefully and ensure their position does not worsen. Where the cash flows do not permit certain banks to receive repayment at the expense of others, or bank’s withdrawal would leave insufficient trading lines, lenders will be left with no choice but to ask for all banks to be treated on equal basis. By that it means requesting the company to immediately stop making any permanent pay down to lenders and immediately calling an all bank meeting.

WHAT NEEDS TO HAPPEN AT THE FIRST ALL-BANK MEETING?

Once the decision made, it is the best that the meeting is called straight away, to ensure all banks are being treated equally and fairly in getting the same treatment and levels of information. Perhaps more importantly, the calling of the meeting creates an immediate temporary standstill agreement among the lenders by invoking protection under the guidelines issued by Chapter 11. The debtor is somewhat protected and a moratorium on repayments to bank creditors essentially created. That is, banks should not take any legal action until they are in a position to make a well-reasoned decision. In other words, they
must at least wait until the accountant’s first report is made available to give an overall assessment of the health of the borrower. The company chairman should clearly state clearly but briefly to the banks what has happened and make it clear to the banks that they are facing reality and are doing everything possible in the best interests of the company and its creditors.

As demonstration, they should have their appointed reporting accountants with them, as well as the company’s lawyers. The latter might be newly appointed if their regular lawyers simply do not have the resources or experience to handle a multibank workout. The company should also have previously asked one bank, usually the largest lender, to be the liaison or lead bank. The accountants should provide a quick overview of the work they are about to commence and indicate when the initial report will be ready. It is best that the meeting is kept short and that any detail is avoided until things are clearer. The whole point of the meeting is to show the banks the company recognizes its troubled position and is taking active steps to get back to financial health, most notably the appointment of accounting and legal advisers and a lead bank. The company and its advisers leave the meeting to allow the banks to discuss any issues among themselves.

**HOW DOES THE MAJOR BANK VIEW ITS ROLE AS LEAD BANK?**

The lead bank is often crucial in securing eventual agreement to the terms of a workout. The usual obvious candidate for the role is the major international bank, largely because of the resources available in terms of manpower and experience. There are only a few multibank workouts happening where global banks do not assume the lead role. Borrowers generally turn to global banks and ask them to lead because they can be trusted based on their past track records. They have built a reputation of not running for the exit upon first hearing of a company’s problems. Borrowers also feel they are confidential in their dealings with them. They also have the balance sheet strength to support borrowers should they wish and are obviously long term players in the business. However, borrowers had not seen them in the same light during the good times. Anyhow, the demands on a lead bank cannot be underestimated. It will often have to provide a delicate balancing act, and provide firm but not overbearing leadership. So long as a workout is proceeding reasonably well, all other banks look to this lead bank to provide strong leadership with limited reference to them. It is becoming largely the lead bank’s responsibility to put in place a rescue package by working closely with the borrower and their advisers.

Banks are now generally fatigued of the workout process, and so they try to keep all banks and steering committee meetings to a minimum, advising of developments by e-mails or fax circulars. There was always general suspicion as to the lead bank’s motives. Were they using the superior levels of information gleaned from the borrower to their own advantage? The lead bank had demonstrated in the past that they take all lenders’ positions into account and do not seek to advantage themselves by having the lead role. Sometimes they could be accused of acting in quite the opposite manner. The lead bank make sure all banks are treated equally on terms of access to information, and that they are seen as objective and not following a route which best suits their own position, but a route which should give the best chance of overall agreement. They have to be flexible and take into account the comments and concerns raised by the banks and the borrower as well as its advisers. There is an equally important role to be played by the other banks in terms of attending meetings, respecting deadlines, raising concerns early and be constructive. The lead bank first duty is always to other lenders. A fee would be charged by the lead bank of all the services they are providing.
WHAT DOES THE LEAD BANK SAY AT THE FIRST MEETING?

In many parts of the world, lenders have few choices in distressed situations because there is no equivalent to Chapter 11. The only realistic alternative is for banks, trade creditors and shareholders to cooperate in a workout. A workout only possible if a company’s banks agree it is an option worth exploring. They have to agree not to press for repayment until the viability of the company has been assessed and a consensus reached on the best way forward. This needs a lot of cooperation. The London corporate banking market has a well-established approach to company workouts. These guidelines are not legally binding, but simply a set of general principles governing how banks should respond to the news that a company is in financial difficulty. In the meetings with banks, the lead bank will summarize these points and suggest that their continued support will probably provide them all with the best overall return. These requires facility lines to be kept in place, albeit reduced to levels of outstanding, and banks to refrain from taking any action that might further destabilize the position. In other words, the lead bank stands up in front of all other banks and hopefully persuades them to agree voluntarily to remain supportive until they have a better idea of the company’s true financial position. The lead bank wants to convince them this is the right thing to do. So the lead bank is using its name and reputation to lobby the other banks and add weight to the company’s request for a moratorium. It is not just after the first all-bank meeting that the lead bank does this. Phone calls and carefully worded letters are often required to halt any squabbling among banks and persuade them to remain supportive.

THE FUNCTIONS OF STEERING COMMITTEE IN A MULTI-BANK WORKOUT

Where there are more than 10 banks, or where a smaller number of banks have very diverse lending positions, a steering committee would be formed. This is ideally made up of 4 to 6 banks with workout experience. It acts as a useful sounding board for the lead bank and its main function is to discuss key issues among a manageable sized group. When ideas have been tossed around and a consensus reached, the committee should submit and recommend a single proposal to the rest of the bank group for approval. The committee has to be representative of the bank group for it to be effective. Again, the committee represents all banks and must ensure their interests are equally catered for. Most banks cannot join the committee to represent their special interests. Unfortunately, there are a number of banks joining the committee purely for their own benefit, either to force an issue which is specific to them or simply gather more information than they would otherwise achieve. The chairman of the committee should make a point of reminding all members at the first meeting that they are on the committee to contribute, to put forward constructive comments and not to simply listen and report back to head office. It is for this reason that the chairman of the committee tends to be selective about who joins.

IN WHAT CIRCUMSTANCES WILL BANKS LEND NEW MONEY?

Companies often need additional or new money to get them through a standstill period. However, companies that get themselves into difficulty are usually poorly managed, particularly in terms of financial management. That means there is generally plenty of room for the financial management to be improved, for better cash management, or more efficient usage of existing bank lines. If the situation is not too bad, improved trade terms can often negotiated with buyers and suppliers, non-core or non-profit generating businesses closed down thereby reducing working capital requirements, unprofitable orders
canceled or sub-contracted, and so on. The banks will fully expect these to be explored and implemented. It is all too easy for borrowers to simply ask their banks for more money given the fact that the initial response will almost always be “no”. It is usually only after financial management has been improved as far as possible that the lenders start to seriously consider requests for new money. In reality, it is rarely needed after the right changes have been made and therefore seldom provided by the lenders. It might be amazed just how many times lenders have been told a company is about to collapse due to a lack of cash, only to see them trading much more efficiently months later. The borrower then pleasantly faced with the ability to part repay bank debt in cash, without much further effort (Rouse, 2002).

Where lenders do provide new money, they expect the reporting accountants to monitor the funds utilization carefully and to monitor actual cash flows against earlier forecasts. Security would almost always be requested and priority ranking given for that amount would be against “old” monies. This obviously requires the consent of all lenders who normally agree. Although new money should ideally be provided on a pro rata basis by all lenders, in practice this does not happen. Some banks may even oppose the idea, arguing the provision of new monies is a waste of time and will simply dilute their return in what they see as an inevitable liquidation later on. Others may have difficulty obtaining approval from their regulatory authorities, or it may simply be against head office policy. Sometimes it is appropriate that certain credit limits be repaid while others need to be increased, depending on the facility mix required by the company. This will likely benefit some banks being repaid, whilst requiring others to increase exposures. To enable this change to be made, a loss sharing mechanism will have to be agreed upon by the banks to ensure all lenders are ultimately treated equal.

CONCLUSIONS AND RECOMMENDATION

This research paper has been intended to convey how banks think and why they act the way they do when they become aware of a corporate borrower’s financial difficulties. Banks’ reactions are heavily dependent on when the borrower disclosed the news and how they then chose to work with their banks. The success or otherwise of a workout is therefore predominately in the hands of the borrower and their advisers. If a 5 cent return to banks is without doubt the best a company can do, banks have recently shown they will accept the proposal and the company will survive. Banks are committed to the maintenance and development of long term relationships with their customers and it is their policy to support them, wherever sensible and prudent, throughout all stages of the economic cycle. Nevertheless bankers must be prepared to make the hard decision when they are placing their shareholders funds at risk. It is also essential that such relationships are maintained on fair terms.

REFERENCES