Corporate finance, banking relationships and the London Rules

*The **Governor** comments[1] on some of the implications of ERM entry for monetary policy and for industry. He notes that for companies the ERM involves additional pressures to contain costs and improve productivity and acknowledges that this will not ease current difficult trading conditions. Against this background there are bound to be individual cases of liquidity difficulty: in some instances the company and its creditors may not find it easy to reach an accommodation. The **Governor** suggests that where this is the case the banking community might find the broad principles embodied in the so-called 'London Rules' a useful guide to action. He makes clear that the Bank fully supports these principles (which provide for a lending standstill and the appointment of a lead bank) and may in some circumstances be willing to act as a neutral chairman: but emphasises that in performing such a role the Bank never seeks to protect or favour any particular group of banks, nor does it dictate that a rescue must be agreed.*

Mr Chairman, Ladies and Gentlemen, may I first express my warmest thanks for your delightful hospitality this evening. It is a very great pleasure to be here.

I hope you and your members will excuse me, Mr Chairman, if tonight I add a few more words to the millions that have already been spoken and written about ERM entry. But I can assure you I shall spare you a full account of the Bank's thoughts on ERM, as I also want to say a few words about company finance, which is obviously the bread and butter of your members' business.

I should start, I think, by expressing a degree of satisfaction with the market response to the great events of nearly three weeks ago. The announcement was, perhaps inevitably, greeted almost euphorically, but things have now calmed down and we are trading in a rather satisfactory way around our central rate.

There has, however, been some uncertainty—almost entirely unnecessary—about the implications of entry. I think the thing to stress here is that the ERM provides a framework for our monetary policy and a discipline supporting it. It most definitely does not—and indeed could not—herald a change of objective. As I emphasised in a speech in Florence last December, while the smaller Community members can use the ERM's deutschemark anchor in an almost automatic way, the larger ERM economies—which obviously now include the United Kingdom—must have a strong inherent commitment to internal price stability as a matter of individual policy; without this, exchange rate stability could not be maintained and the mechanism itself would in time become threatened. This is a commitment that lies at the heart of UK economic policy, and means that interest rates will continue to be directed to achieving exactly that price stability.

The implications for industry are, I hope, becoming widely understood, although I suspect that it will take more than pious utterances from the authorities to convey the reality of the situation. And this is that ERM membership will place pressure on management to contain costs and improve productivity. The defeat of inflation absolutely requires this as cost-push pressures are replacing the demand-pull pressures we saw earlier. But I recognise that in the short run—I emphasise the *short run*—it will not ease the difficult trading conditions that companies presently face.

We should not forget that company profitability was high in the late 1980s, helped by buoyant world markets and strong demand at home. Margins on both export and domestic sales have been healthy. As I say, however, the current environment is more difficult. Many companies now find themselves facing high debt servicing costs, falling domestic demand for their products, and inflationary wage claims. There is consequently considerable pressure on company profits and even greater pressure on cash flows. To a large degree, this reflects a past build-up of debt arising from strategic investments, mergers and acquisitions and historically high dividend payments. These are all of course things that can be adjusted—some quite quickly—so many companies *will* be able to manage in a tougher economic environment. Firms which restructured in the early 1980s may also be better able to cope, although equally some of them may find they have less fat to cut this time round. It is difficult—and probably impossible—to make any generalisations about this.

(1) In a speech at the Annual Dinner of the Equipment Leasing Association, on 25 October.

Perhaps the only certainty is that companies with high levels of capital and income gearing will find it harder to adjust. And I am afraid that, against this background, there are bound to be continuing individual cases of liquidity difficulties.

At the best of times, a company's liquidity requires active and careful management. But the task becomes many times more complex when trading difficulties arise, and this is further compounded when a large number of banking relationships are involved. The key question for creditors is simple enough to express. It is whether to put the company into administration or liquidation as quickly as possible—or, alternatively, to attempt to bring the company's liquidity situation back under control. But how is this vital judgement to be made?

Understanding this problem is, I think, helped by reminding oneself of the usual pattern of events. The alarm bells generally ring first on a realisation, which can often be sudden, that a company cannot raise the cash to pay its immediate bills. Sometimes it is the company which blows the whistle; sometimes one of its bankers. This could be a small bank which is seeking to reduce its loan book and so tries to pull a line, or it could be the company's main bankers who see that its overdraft is creeping uncomfortably upwards and is exceeding agreed limits. Typically, a meeting will be called, to which easily identifiable creditors are invited. Three things often become evident at this stage. The first is that no-one, including the company, has a sufficiently complete and robust picture of the company's financial position to make a soundly-based decision on its future. Secondly, the amount of debt, including off-balance-sheet items, and the number of creditors are usually larger than anybody supposed. And thirdly, it is far from uncommon that the creditors find they have varying interests.

Very often, the company, its advisors and its creditors succeed in overcoming these obstacles. And perhaps the most important thing for me to say this evening is that in the vast majority of cases the work-out process works well and smoothly. But there are instances—which fortunately are relatively rare—where an accommodation is not easily reached.

This is when it can prove helpful for the banking community as a whole to be able to look to certain broad principles. Such principles have existed in London for many years; and have recently become known as the 'London Rules'. It has to be said that these so-called Rules are not really rules at all. They are rather a guide to action which can be helpful if everyone agrees to follow their spirit. In fact, they are not very different from those which emerged in relation to third world debt almost a decade ago, and can be summed up by one single precept: bankers who voluntarily take on a banking relationship in good times share some responsibility with the rest of the banking community to contribute to an orderly management of crisis.

Beyond that, there are perhaps three basic features of the rules which are particularly useful. The first is that, when difficulties arise, a lending standstill should be considered so that a proper analysis can be made of whether continuing support—and particularly additional financing—is justifiable. Secondly, the fullest possible information should be gathered to support that analysis and the subsequent judgement. And thirdly, there is a very important role for the lead bank. (Often this will be one of the clearing banks, because by reasons of size and tradition they are usually the main bankers to any UK business. But this is not invariably the case; sometimes it is an overseas bank.) Whatever its size or home base, the lead bank needs to ensure that all interested bank creditors are informed of the company's position at the earliest possible stage, and are *kept* informed. This is of help to all creditors, and particularly the smaller banks. No-one should be—or feel—disadvantaged through lack of information.

As is well known, the Bank of England fully supports these principles. But we do not see them as some kind of magic potion. They depend on goodwill and they do not address every possible complication. For example, a lending standstill usually involves *pro rata* burden sharing. But this is easier to declare than to implement because the nature of different creditor claims can make it very hard to determine quite where equity lies. A small participant in a undrawn but committed facility may feel less obligation than a bank providing a large part of the problem company's working capital through an overdraft facility.

It is for this and other reasons that there can sometimes be a role for a neutral chairman who is seen by everyone to have no financial interest whatever in the outcome. This is a role which the Bank of England may be willing to play—our actual willingness depending very much on the circumstances. Every case is different; it is impossible to set in concrete when we are prepared to help, and it would be wrong to try.

Crucially, a lead bank must emerge which is able to take on the onerous task of managing relationships between the creditor group and the company. And it is also vital that a clear majority of the banks is willing in principle to try to agree a financial workout. Without that, a neutral chairman would be resisting the tide of market forces, and we are not willing to do that.

And perhaps at this point I should therefore address some of the misconceptions that have become apparent, both about the 'Rules' and the Bank's role in this area. First, the Bank never seeks to protect or favour any particular group of banks or other creditors. It is true that some of the smaller banks—and indeed some of the foreign banks—sometimes find themselves in a relatively passive position, but this reflects their role in UK corporate financing and most definitely not their size or nationality. Secondly, the Bank does not dictate that a rescue must be agreed. It is the creditors' money that is at stake, and if they collectively feel that liquidation or administration is the right course, then we accept that. Our aim is to ensure that a rational decision is reached on the basis of as full an understanding as possible

of the company's position and, just as importantly, of the possibilities of a rescue. This means that the creditors as a group must talk to each other. And when this is proving impossible, as I said we may be willing to help.

Mr Chairman, these are all topical issues just at the moment on account of the stage of the business cycle we have reached. But perhaps I could conclude by identifying some general lessons which can, I think, be drawn from recent experience and which should be remembered during the next upturn. I offer these thoughts with some hesitation because they are not visibly different from what my predecessor as Governor said after the 1981–82 recession. The first is that all parties involved—companies, their financial advisors and creditors—need to think much more about the nature of their banking relationships. The plethora of transaction-related links may be attractive to a corporate treasurer during good times, when he can shop around in search of the finest terms; but it is not surprising that those creditors have a relatively shallow grasp of the realities of the company's business and a corresponding level of commitment. Secondly, and something which we cannot repeat too often, bankers need to monitor the risks that they take on very carefully, even when they are only junior members in a syndicate.