The London Approach

Pen Kent, the Bank's Director for Finance and Industry, explains[1] the voluntary, collective approach, adopted by banks in the United Kingdom, when faced with a company in financial difficulty. The 'London Approach' is designed to ensure that decisions about whether to call in receivers on the one hand or to organise a 'workout', or company support operation on the other, are orderly and well-founded. Its purpose is essentially to help the financial community preserve value. Pen Kent paints an encouraging picture of its application during the past three years which has allowed many businesses to survive which might otherwise have been wholly or partially closed. However, he argues that there is no room for complacency. Recent experience has highlighted a number of possible improvements which could make future support operations easier to manage successfully. Among the issues he addresses are the problems of achieving unanimous support from a large and diverse group of banks: the importance of establishing sound and informed relationships between borrowers and lenders; the need to consider, and where possible include, bondholders, shareholders and other non-bank creditors in discussion about a company's future; and the importance of minimising costs, at a time when a company's cash resources are often already in short supply. In his conclusions, Pen Kent outlines an 'agenda for action' through which he seeks to ensure that the lessons of past experience are learned and the problems of tomorrow anticipated today.

Introduction

An ideal world, from a lending banker's point of view, is one where surprises are infrequent and always pleasant. The real world, of course, has been very different. There have been an uncomfortably high number of surprises coming from the corporate sector during the past three years and most have been ones that the banking community could well have done without.

The recession has lasted longer, and cut economic activity by more than most of us had expected, with the result that an unprecedented number of businesses of all sizes have looked to their bankers for a lifeline to enable them to survive. This has included some well-known names: Berisfords, News Corporation, Brent Walker, WPP and Ratners, are but a few which are in the public domain.

How banks respond to appeals for assistance from companies in financial difficulty is crucial not just for their own profitability but also, at a national level, for future levels of productive capacity. It is in everyone's interest that businesses which offer a reasonable prospect of viability survive and that only those which by general consent are hopeless cases are put into the hands of liquidators.

My intention this evening is to consider what issues have arisen in dealing with cases of corporate financial difficulty in the past few years. I also want to go beyond this. I would like us to leave today with a clear 'agenda for action', to ensure that the lessons of the past are learned and shared and that the issues of tomorrow are anticipated today.

Workout or insolvency?

Let me outline a situation that has been all too frequent during the past three years. A company, with banking facilities from perhaps thirty banks, together with outstanding commercial paper and bonds, tells the agent bank of its largest lending syndicate that it thinks that it has breached an interest cover covenant. At the same time it reports that sales have been lower than planned, and that, as a result, it will need additional lending facilities. Because of cross-default clauses in other financial facilities, a single breach of covenant normally puts a company in a position where its entire borrowing is repayable on demand. The directors of a company, conscious of their obligations under the Insolvency Act, would find it very hard to continue trading in such a situation. Based on my experience of the past three years, the breach of the covenant would probably come as a surprise, both to the company and to most of its banks, which, for various reasons, will have tended to keep at arms' length.

How would you, as lenders to this company, respond to this situation? If you were comfortably secured, your initial reaction might be to consider appointing receivers to recover your lending. However, unless there was an obvious net surplus of assets, other lenders without security, or with inadequate security, would be unlikely to see much

(1) In a speech to the Chartered Institute of Bankers on 12 November 1992.

advantage, if any, for themselves in receivership. This would be especially so in situations where the publicity associated with receivership could damage severely a company's ability to trade, or where a sale by a receiver could seriously undervalue its assets.

What alternatives are there to receivership? The 1986 Insolvency Act widened the choice: we now have Administration and Corporate Voluntary Arrangements, both aimed at allowing creditors to form a considered view of the best way forward for a business in financial difficulty. Unfortunately these procedures have not so far proved very practicable, with the result that, more often than not, companies find that the only realistic alternative to receivership is for their bankers, trade creditors and shareholders to co-operate in exploring the possibility of a workout. (I am using the term 'workout' to describe a non-statutory agreement to extend financial support to a company, which, without this support, would have to cease trading. I could easily have used the terms 'support operation', 'intensive care', or 'corporate rescue' instead.) Certainly, as in my example mentioned earlier, an attempt at a workout is likely to be the preferred option for the overwhelming majority of creditors: the only exceptions are perhaps lenders in the fortunate position of being fully secured or those with a *de minimis* exposure. There is little doubt that other stakeholders in a business, not least its employees, will prefer the lending banks to explore the possibility of a workout rather than to appoint receivers, notwithstanding the fact that receivers will endeavour to preserve as much of a business as possible as a going concern.

A workout is only possible if a company's bankers are of a like mind that this option is worth exploring. They must agree not to press to be repaid until the viability of the company has been assessed and a consensus reached on a way forward. Secured creditors (with the right to appoint a receiver to recover their lending) must, in particular, agree to stay their hand. And non-bank creditors who may have the power to bring down the company must refrain from making demands for repayment. This clearly entails a substantial degree of co-operation.

Features of the London Approach

The London corporate banking market has, since the late 1970s, developed what is now a well established approach to company workouts. This London Approach does not lay down 'rules' or detailed guidance but comprises certain general principles governing how banks and other creditors should respond to news that a company to which they are exposed faces serious financial problems. It has evolved with encouragement from the Bank of England.

The main tenets of the London Approach are:

- Banks remain for the time being supportive on hearing that a company to which they have an exposure is in financial difficulty. In practice, this means that they keep their facilities in place and do not rush to appoint receivers.
- Decisions about a company's longer-term future are only made on the basis of reliable information, which is fully shared among all bank creditors.
- Banks work together to reach a collective view on *whether* and *how* a company should be given a financial lifeline.

In short, the objective of the London Approach is to ensure that decisions about companies' futures are orderly, considered and well-founded.

The London Approach does not have any formal status; it is not statutory. It can only be effective if it commands general support within the London banking community. This means that it must offer banks the prospect of recovering at least as much of their outstanding lending as they would obtain by alternative routes, such as receivership. Thus, a central aim of the London Approach is to maximise value for financial creditors. There have, I believe, been plenty of cases during the past three years where the application of the London Approach has done precisely that. Its application has allowed businesses to survive, which would otherwise have probably been wholly or partially closed.

The role of the Bank of England

The Bank of England strongly supports the London Approach as a sensible way of responding to corporate financial difficulties. We stand ready to offer whatever help we can to resolve difficulties which threaten to scupper a workout. We can act as an honest broker and are regarded, I hope by all sides, as an independent and neutral mediator. We have the advantage of being detached from the immediate pressures of crisis which can sometimes lead to misunderstandings and strained relationships on a personal level. This allows us to bring a fresh perspective to a problem and thereby to be better placed to help break log-jams in the negotiation process. We try to ensure that all parties are given an opportunity to voice their concerns so that no participant feels ignored. Our main aim is to bring negotiations to a satisfactory conclusion, one which, although perhaps not the first preference of all parties, is still an acceptable compromise.

There are no conventions as to who may draw cases to our attention. We are happy to be approached by anyone, whether they be a lead bank striving to achieve unanimity, or a minority member of a syndicate which feels that its own particular concerns are not being properly addressed. We operate an open-door policy and will speak to any player involved whether large or small, domestic or foreign. The approach usually comes from a creditor bank but occasionally it may be from the company's financial advisers, or even the company itself.

Some history

But before I go into some of the lessons of current experience, I want just to reflect on why the Approach is needed. Quite simply the competitive rush in the 1980s to transactions banking led to too many banks lending too much money on too little information. By transactions banking, I mean the tendency of corporate treasurers to look at each separate banking deal in isolation and as an opportunity to squeeze down margins. This may be fine for cash rich companies, but for those who are not, it can lead, as we have seen, to disaster. It is not uncommon to find that a company in difficulty has far too many banking relationships to be manageable as confidence begins to evaporate. Nor is there much incentive for loyalty from many of them.

This inherent weakness in the transactions banking approach was compounded by the lack of adequate mechanisms to ensure a flow of full, timely and frequent information and then to monitor the trends in order to spot trouble coming while it could more easily be dealt with.

One of the reasons perhaps why the banks allowed this to happen was that they took comfort from the presence of security, back-up facilities or guarantees which in the crisis turned out to be illiquid, illusory or even a channel not of support but of infection.

Recent experience of organising company workouts

The London Approach has received quite a testing during the past three years. It has formed the basis of virtually all recent major corporate workouts, and it has, I believe, acquitted itself well. There have been comparatively few cases that we know of where attempts at organising workouts have failed because the banks concerned could not agree among themselves. I do not want, however, to be complacent. Securing the agreement of a group of banks to the terms of a support package is never easy. Let me now turn to some of the issues which have surfaced in applying the London Approach over the past three years and the lessons we might draw.

The need for unanimity

A workout can usually only go ahead if it commands *unanimous* support; no bank will willingly agree to its exposure to a company being increased in order to allow another bank's lending to be repaid. Unanimity is, of course, often difficult to obtain. It is no easy thing to secure agreement to a common set of terms for a workout from upwards of 20 banks with differing levels and types of exposure. In addition, there is the free rider problem. An individual bank may have an incentive to be unco-operative in interbank discussions if it hopes that other banks involved will thereby agree to refinancing its lending. Unlike statutory procedures, an overwhelming majority cannot compel a minority to join a workout; the minority must be persuaded of the merits of joining a support operation.

The London Approach does not remove the right of individual banks to make their own commercial judgements but it does recognise that, where the vast majority of banks agree on one particular strategy, those banks holding a different view also have a long-term interest in preserving the co-operative culture. In that light they may reconsider their decisions on the basis of the collective good. While a bank may not be entirely happy with every aspect of a support package, it may be willing to accept that what is on offer is preferable to the alternatives. It might reach this conclusion because it fears that failure of the banks concerned to agree on the terms of a workout may result in a receivership which would be in no-one's interests. Another consideration is that there is undoubtedly a significant degree of market pressure, often unspoken, that may deter a bank from taking a stance perceived as unreasonable by their colleagues. A bank which frustrates an orderly workout for a company may find that other banks are less likely to be constructive next time round when their roles are reversed.

I would like to suggest that we seek a way of removing the need for unanimity before a workout can go ahead and as a matter of course substitute qualified majorities. Indeed some of the minority banks might themselves prefer the streamlining which this would bring to collective decision-making.

Information sharing and clarification of responsibilities

I cannot help feeling, with the benefit of hindsight, that some of the problems which have surfaced in the organisation of workouts could have been avoided if more forethought had been given when loans were arranged. My remarks are perhaps most addressed at syndicated loans but many apply equally to bilateral facilities.

Let me give some examples of what I have in mind:

- All too frequently we hear of banks who failed to undertake their own credit assessment, taking comfort from the standing of the arranging bank.
- Syndicates were, with hindsight, often unmanageably large, comprising banks from different backgrounds and with widely differing levels of exposure.
- Another recurring theme is the lack of reliable and up-to-date information, both when a loan was put in place and subsequently for monitoring purposes.
- Loosely drafted loan documentation has compounded difficulties by failing to give clear guidance when put to the test.

Many of these problems reflect the competitive pressures of the 1980s and I am conscious that much has already been done to change market practices. It is essential that when times improve, good practice does not lapse! I would like to suggest some further steps which might be taken to help avoid such problems in future:

- Syndicates should be of manageable size.
- Covenants should aim to be unambiguous, realistic and achievable. Banks should not rely on catch-all

'material adverse change' clauses which have a hair trigger.

- Banks should seek timely information from the borrower and use it.

The importance of the lead bank

Our experience over the past three years has highlighted the crucial importance of the *lead bank* in securing agreement to the terms of a workout. Usually there is an obvious candidate for the lead bank role, although there are no hard and fast rules as to who it should be. It does not have to be the bank with the largest exposure, or the agent bank for a company's main lending syndicate, or the company's overdraft banker. What it does have to be is a bank with adequate resources in terms of manpower and experience. The demands on a lead bank should not be underestimated. It will often have to perform a delicate balancing act. It must provide firm but not overbearing leadership. It must take great pains to ensure that every lending bank is provided with the fullest information possible. It must be seen to be objective, to be acting in the best interests of the banking group as a whole and not to be pursuing its own agenda. It must, perhaps above all, be flexible (for example, to know when to give ground in difficult discussions). You might conclude from this that a lead bank needs to be staffed with supermen! However, there is another side to this coin; there is an equally important responsibility on all the other lending banks to attend meetings, respect deadlines, raise concerns early and perhaps above all to be constructive.

Steering committee

Workouts which involve more than a handful of banks, or where the banks concerned have very different exposures, often benefit from establishing a *steering committee*. A steering committee can serve as a useful sounding board for the lead bank and will help to improve communication within a syndicate. It must, however, be representative; all banks must feel that their voice will be heard. We have perhaps been rather slow in appreciating the contribution that a balanced steering committee can make to the success of interbank discussions—or rather in realising the jeopardy created by an unrepresentative one.

Some banks have been reluctant to serve on steering committees. I have little sympathy for these banks if they subsequently complain that proper account is not being taken of their views. If a bank stands to benefit from a successful workout, it must be prepared to contribute to achieving this end.

The involvement of non-bank creditors

Workouts are usually the domain of the banks because they are often the only feasible source of succour for an embattled company; they constitute a readily identifiable and manageable group, in contrast, for example, to holders of shares, bonds or commercial paper, and they are invariably some of the largest individual creditors. There is, however, no reason in principle why other groups of creditors and shareholders should not also participate. Where practicable, I believe it is preferable for such creditors, in particular holders of bonds and commercial paper, to be brought into a workout. Indeed, from the point of view of spreading the risk of extending temporary support to a company, the more that are involved the better. However, it is impossible to draw up hard and fast rules. Pragmatism is usually the best guide, but it is an issue which should be confronted openly and early in a crisis.

Fees and costs

It is normal practice for the company which is the focus of a workout to bear the costs involved. Thus, it will pay for reports by investigating accountants and for legal advice associated with the drawing up of the terms of a workout. In addition, it is customary for banks, and others involved in extending financial support via a workout, to protect themselves against the additional risk that they are assuming by taking security and by widening their lending margins. I believe that these arrangements are perfectly justified, provided that claims for cost reimbursement, and charges levied for the provision of financial support, are reasonable.

Fees and costs are, however, never too low; they are always too high, especially those which are paid up-front and which can aggravate a shortage of working capital at a critical stage. Indeed, while it is widely argued—though I am not aware of any supporting figures—that workouts are less costly than statutory forms of insolvency, there has been some disquiet recently about the aggregate level of professional fees which have been levied in connection with some workouts. I know of a number of cases where the costs associated with a proliferation of advisers have led to a real risk to the future of the company concerned. Banks need to ensure therefore that their expenses are reasonable and are seen to be reasonable. Lawyers and accountants are of course expensive, but care does need to be taken to minimise advisors' costs—perhaps by banks sharing a single legal advisor for example and by giving careful thought to terms of reference when commissioning advice. If the client ie a commercial bank does not pay the bill for advice, there is less discipline on time and cost. Unless we in the City collectively can minimise these costs in a sensible way, even if it sometimes entails overlaps or even some conflict of interest, we shall bring ourselves into disrepute.

Sales of debt

Debt sales during workouts are a relatively new development in this country. It is easy to understand why a bank may want to off-load a troubled company loan: some lenders may prefer to take a short-term loss by selling their debt at a discount rather than sign up to a refinancing or restructuring which may lock them in for a number of years.

Sales of debt by one bank to another bank involved in a workout may actually facilitate interbank discussions by reducing the number of parties. But I am concerned that, in the majority of workout situations, debt sales will impede progress. Indeed, selling debt in response to news that a company is in difficulty is not in keeping with one of the basic tenets of the London Approach, namely that banks should be supportive of a company which has announced that it is in financial difficulty. There is a risk that banks might put priority on trying to extricate themselves from discussions on a possible workout in much the same way as shareholders who sell their shares in response to bad news rather than seeking to tackle the root cause of the bad news. There is also a risk that sales of debt while discussions on the terms of a workout are taking place will bring new players into the discussion whose commitment is unknown and who will need to be brought up to speed in terms of information and understanding; this can disrupt discussions. To avoid this happening, perhaps the banking community should consider a code of conduct to minimise disruption during the formulation of a workout. This could include for example understandings about the responsibilities which attach to a debt which is on-sold. To the extent that majority voting replaces unanimity, any difficulties should be reduced.

Other issues

There are two other issues which I should like to mention, neither of which I believe need present particular difficulties.

- *Conflicts of interest*: banks participating in a workout are frequently faced with a number of potential conflicts, many of which may be impossible to avoid. However, I am a firm believer in openness and that, whatever the nature of the conflict, if it is declared at the earliest opportunity, it should be possible to prevent it from impeding progress.

- *Responsibilities of banks as shareholders*: one increasingly frequent consequence of workouts in recent years has been that banks have become shareholders in the companies concerned—a situation which they have historically tended to avoid. This can undoubtedly be viewed in a positive light, demonstrating banks' support and commitment to the longer-term future of the companies. Notwithstanding the need to address conflicts of interest, I believe the banks should take an active role as responsible shareholders. This means giving careful thought to the governance of the company—have they got the right Chairman and the right Board structure, for example? Furthermore it is necessary for the banks to separate this role clearly from that of creditors to the company.

Conclusions

The London Approach commands widespread acceptance in the banking community because it is seen to be fair and flexible. It has, in my view, acquired a pretty impressive track record over the past three years. A large number of companies owe their survival to their banks, and thus, indirectly to the London Approach. Press attention has often focused on how many companies have been put into receivership by banks. But what I've been talking about today is the other side of the story—the large number of companies which owe their continued existence to their bankers.

I would like to see the banking community build on the wealth of experience which has been acquired during the past three years in dealing with the financial difficulties of companies. While the system of collective workouts, reflected in the London Approach, has been pretty effective, there have, as I have outlined, been some areas of difficulty, albeit none which have proved insurmountable. We should, however, be constantly looking for improvement.

It is worth remembering that there is also, increasingly, an international perspective to these situations. Although other countries have differing cultures and systems, there have been examples of overlap where some of the lenders, or parts of companies, are based overseas. International co-operation has worked reasonably well to date, as the players in other markets have experienced similar conditions to those encountered here and we need to take care to understand others' systems and to explain ours. However, our culture of co-operation with the informal support of the central bank is not understood everywhere and we cannot therefore take automatically for granted that we can count on support from overseas.

I am sure that I can speak for most of the bankers involved in the detailed, and often heated, discussions which surround workouts, in saying we should try to avoid last-minute scrambles. Are there some ways of avoiding such situations? Let me air a few ideas.

One of the characteristics of many of the workouts of the past three years is that most of banks with loans or other types of exposure to a company did not have a full or up-to-date picture of its financial position. This state of affairs was largely a reflection of the trend during the 1980s towards transactions banking. The corporate banking market has already begun to move back towards closer bilateral relations with corporate customers. For example, the days of large lending syndicates look as if they are past. The question has been posed in a number of fora, however, whether London would benefit from the establishment of a central credit register (or centrale des risques) such as exist in many continental European countries. I have my doubts about whether such an institution would be effective in an open market place such as we have in the United Kingdom, but I am willing to consider carefully the counter arguments which are now being assembled with our help by some of the continental banks in London.

Recent experience has highlighted weaknesses in the operation of certain aspects of the 1986 Insolvency Act. This is perhaps not surprising as that Act marked the first major overhaul of insolvency law in the United Kingdom for more than 50 years, and it is only in the past few years that we have seen it in action. Perhaps most disappointing is the relatively limited use made of the Administration and Corporate Voluntary Arrangements procedures. I would like to see a detailed review of the working of these parts of the

Insolvency Act to explore ways of making these procedures more usable. The main advantage of a statutory workout procedure is that it would not require unanimity, which, as I have described, is one of the main weaknesses of our current voluntary workout system. A revamped Administration or Corporate Voluntary Arrangement procedure would allow a proposed financial restructuring which commanded overwhelming majority support among creditors to be made binding on the dissenting minority.

So what of my 'agenda for action'? I believe the issues to be addressed immediately to maximise the effectiveness of the banks' response for the present situation are:

- How banks might improve their awareness of a company's indebtedness.
- Can we dispense with unanimity?
- Is there scope for greater clarity and precision in loan documentation, possibly through a code of conduct for arrangers of syndicated credits?
- Can fees be lower on aggregate (by sharing resources) and controls introduced to ensure accountability?
- How might a secondary market in debt develop without impeding workouts?
- How to ensure that banks do not neglect their corporate governance responsibilities.

But of course the real lesson, ie the big agenda for the future, is how to prevent a re-occurrence of the credit failures of the early 1990s. I suggest that a return to some kind of relationship banking is the first, most important and key step. This is a lesson for both sides of the banking relationship—the borrower as well as the lender. From this should flow a major improvement in information flows and the use that is made of them. Indeed, there are already signs that the process has begun. Banks are putting more weight on the cash flow of borrowers and less on the security they have to offer. If we all keep our nerve in the meantime, there will be more survivors to benefit from these lessons.