The London Approach and trading in distressed debt

The Head of the Bank's Business Finance Division, Michael Smith, discusses[1] *how the nature of corporate workouts is changing with the globalisation of financial markets. The involvement of larger, more internationally diverse lending groups means that, in the absence of international harmonisation of insolvency law, the most effective approach to workouts will be some form of international understanding, building in part on the past successes of the 'London Approach'. He describes the London Approach as a flexible framework rather than a detailed set of rules, which can be adapted in line with changing market practices. He sees the development of a secondary market in distressed corporate debt as having a potentially helpful role to play in future workouts and assesses its likely impact. He concludes by stressing the need for an orderly, professional market.*

Introduction

There has already been some discussion today about the development of a secondary market in corporate debt here in the United Kingdom and how it compares with the more developed market in the United States. The Bank of England's specific interest in the secondary trading of corporate debt has evolved particularly out of its links with corporate workouts and the impact that debt trading has on the practical application of the London Approach. We also have a more general interest in the development of corporate finance markets and the changing nature of the relationship between the users and providers of finance.

I want to start by explaining some of the main features of the London Approach. To many, this may be familiar territory, but I think it is important to ensure that we all have a proper understanding of the basis for the non-statutory, market-led system which has evolved in the United Kingdom over the last 20 years or so. I then want to go on to highlight the changing nature of corporate workouts, not least as the process of globalisation of financial markets gathers momentum, and to dwell on the challenges facing the London Approach. One of the more significant changes in this respect has been the emergence in the United Kingdom of a market in corporate debt, particularly that of 'distressed' companies. What are the advantages and disadvantages of this new market, and can this new market and the London Approach accommodate each other?

In looking at these questions and issues, I am assuming that corporate workouts in the future will be more international in scope and will embrace an increasingly diverse range of financing techniques. The challenge is to ensure that the flexibility and dynamism of the London Approach, which has been one of its major strengths, can be preserved to accommodate these relatively new developments.

The London Approach

In the course of recent workout discussions we have been aware that some of the firms active in secondary debt trading are less familiar with the London Approach framework than those who have lived with it, especially during the last recession. Let me spend a little time clarifying what the London Approach is, or rather is *not,* and dispelling any misconceptions about the Bank of England's role. I recognise that it can appear to some as rather odd that the central bank has an involvement in such an area. As we are indeed virtually unique among central banks in our participation in company workouts, it is not surprising that our role is sometimes misunderstood.

Our motives for becoming involved in workouts have been fourfold:

- it is economically wasteful if workouts founder simply because lenders cannot agree among themselves;
- it is equally wasteful if companies are consequently liquidated unnecessarily; jobs and productive capacity should be preserved wherever they are viable;
- co-operative behaviour helps to maximise value—or minimise loss for banks and other stakeholders; and
- we are well-placed to carry out a facilitating function, having close contacts with all sides of the financial community.

In this context, it should be remembered that the United Kingdom's insolvency system is very different to that in the United States. Insolvency over here (Receivership and Administration) tends to be a last resort, in contrast to Chapter XI which, I know, is widely used—some would say

(1) In a speech to the International Business Communications Conference 'Trading and Investing in Distressed Debt' in London on 1 February 1996.

over used—for corporate restructuring. This difference between insolvency systems is a point I shall return to.

Description of framework

The London Approach is *not* a set of detailed rules, but is a flexible framework which enables banks and other interested parties to reach well-based decisions about whether and on what terms a company in financial difficulty might be allowed to survive. Its key features are:

- lenders are initially supportive and don't rush to appoint receivers;
- decisions about a company's future are made on the basis of reliable information which is shared among all the parties to a workout;
- such information provides a basis for lenders and other creditors to work together to reach a collective view on whether and how a company should be given financial support;
- pain is shared on an equitable basis.

These are 'common sense' principles which, together with a number of more detailed 'conventions'—for example super priority being afforded to new money—have developed within the banking community to serve their financial and 'reputational' interests.

The Bank's role

I should emphasise that the role the Bank of England has played has changed over the years. My predecessors in the 1970s and early 1980s became very closely involved in individual workouts, virtually taking the lead, for example, in suggesting possible terms for refinancings and persuading lending banks of their merits. Our role during recent years has been very different. We have not sought to be prescriptive, but have responded to requests to help the lenders involved in a workout agree among themselves the terms of a refinancing.

The London Approach is *not* a statutory process and has nothing to do with regulation. I am not speaking to you as a supervisor of banks. The Bank has no statutory powers for what we do as an intermediary in the context of workouts. We rely instead on the authority vested in us by the constituent members of the London banking community who continue to seek our assistance in resolving difficult issues. The London Approach is voluntary and it is widely used because it is seen to work and to be fair.

The Bank does *not* seek to impose solutions, nor do we make decisions on the fate of companies; that is for those with an exposure to decide. Our role is part missionary and part peacemaker. As *missionary*, we advocate the London Approach as a sensible basis for lenders to co-operate, in a constructive way, in deciding the fate of companies facing a cash-flow crisis. As *peacemaker*, we try to help lenders resolve differences of view which threaten to undermine an attempted workout. We are willing to be approached by any lender which thinks that our involvement would help smooth the path to an eventual agreement on the terms of a workout.

To give you an idea of the scale of our involvement, we were actively involved in some 160 multi-lender workouts during the early 1990s recession and have been kept informed of many others by the banks concerned. There are many others where we were not involved at all—it is up to the lenders involved to approach us if they want to seek our assistance. When we do get involved, our aim is to break log-jams and to seek a solution which represents an acceptable compromise for those concerned. In other words we act as a mediator or 'honest broker'.

Changing nature of workouts/need for an international understanding

Thanks to the London Approach, a large number of UK companies owe their continuing existence to the fact that their bankers and in some cases, bondholders and other creditors have followed its precepts in deciding the terms of a collective restructuring. However, no-one claims the London Approach is perfect. One of its greatest strengths, as I have already mentioned, is its adaptability. It needs to be kept under review to ensure that its effectiveness is not diminished by financial innovations or changing market practices.

For our part, we have been talking in the last six to nine months to a wide range of interested parties including lawyers, accountants and, as you would expect, bankers, to take their mind on the challenges which lie ahead for those attempting to help companies in financial difficulty. The globalisation of financial markets will have an inevitable impact on the nature of future restructurings. Some of the most challenging in the past have been those involving multi-national companies that had raised finance from a diversity of lenders in a diversity of countries: News International, Heron and GPA, to name a few.

Systems of decision-making on the fate of companies differ across countries. Many of you are familiar with the statutory Chapter XI procedure in the United States, although some US workouts are achieved without resort to Chapter XI. Alternatives to statutory insolvency procedures can be found in Japan and Germany where it has been common for a company's *Hausbank* to assume sole responsibility for sorting out any financial difficulties. Here in the United Kingdom, companies have tended to raise their debt finance from a wide range of lenders, mainly banks, necessitating a collective approach. Competitive pressures have made it unrealistic to expect one bank to shoulder the burden and mount a workout alone; neither would one lender willingly assume a competitor's lending.

Some of these approaches are becoming less sustainable as workouts become increasingly international. Statutory

insolvency procedures have limited effectiveness because they are currently national in scope. A few exceptional cross-border examples exist, using a combination of national insolvency procedures—the Maxwell US/UK protocol is a case in point. An ideal response to the globalisation of business and finance would be the international harmonisation of insolvency law. This is, I fear, something of a holy grail, but at least there are some encouraging signs of judicial co-operation as well as potentially successful efforts to achieve mutual recognition of national procedures among EU member states.

Thus, we come to the conclusion that a collective approach is the most appropriate way of tackling the issues which lenders face when a multi-national company runs into financial difficulty. The chances of a successful workout are greatly improved if lenders have a common understanding of how to achieve a shared objective. Just as the London Approach evolved over the years, I firmly believe there is a need to have a similar understanding which is international in application. This is undoubtedly a tall order and requires an understanding of each others' systems and objectives. However, work is underway in this area and we wholeheartedly support current informal efforts to develop such an understanding, especially through a recently formed INSOL Lenders' group here in the United Kingdom.

I know that a few lenders are still unconvinced that such an understanding is necessary. Why can individual lenders not be free to obtain the best deal from their own perspective? Our fear is that such jockeying for position could be disruptive, deflecting attention from the underlying issues. Long-term relationships in the lending community can also be soured by such horse trading and, in extreme cases, a fundamentally sound business could fail.

Evolution of a UK secondary debt market

One of the main developments affecting the London Approach in recent years has been the evolution of the secondary market in distressed corporate debt within the United Kingdom. We first highlighted debt trading as an area of growing importance at the end of 1992. The debate about the pros and cons of debt trading has progressed and the volume of trading has continued to grow.

I see debt trading as having a potentially helpful role to play in future workouts and, in exploring how best to integrate it within the London Approach, we have been asking for ideas and reflecting them back to a wider audience in order to judge the reaction.

I believe the impact of the development of a secondary market in distressed corporate debt here in London will be felt in several ways:

- Drawing a parallel with the secondary market in third world debt, trading corporate debt can introduce liquidity into banks' loan portfolios and be used as a tool for sound portfolio management. Additionally, a sufficiently deep and well-educated market might provide a useful guide to the extent of provisioning which might be appropriate in individual cases. However, some of the concerns expressed to us, particularly by banks already established in the London market, highlight the potential damage and uncertainty that can arise from poor communication and unfamiliarity with existing practices.

- In the context of corporate workouts, the market represents something of a two-edged sword. Trading can provide a useful exit route for lenders unwilling to participate in what could be a painful restructuring. This leaves those with a genuine desire to add value to agree the terms of a restructuring. On the other hand, it could delay the process of achieving agreement on the terms of a workout, or even undermine it.

There are some potential dangers arising particularly from the lack of consensus on market practices. There needs to be a dialogue to decide how best to incorporate traders of or investors in distressed debt in company workouts to everybody's benefit. Let me explain:

- The timing of trades can have an unsettling effect on restructuring discussions. While it can be helpful in the early stages of a workout, debt trading can bring new faces to the table when discussions are well advanced. This can be disruptive since newcomers will need time to bring themselves up to speed on the situation and may want to go over ground already covered in earlier discussions. This is often not a realistic proposition. Workout discussions have not yet failed as a result of such disruption, but we have come close on a number of occasions. While much of the debt traded in the United States is of companies in Chapter XI, the lack of statutory protection against creditor demands in the United Kingdom introduces a pressure to conclude a workout as quickly as possible.

- There is also the question of the buyer's objectives. While it is possible that some parties may be motivated by short-term arbitrage or the desire to gain access to information, we have seen no compelling evidence that this has been the case. Some may argue that this type of trading does nothing to secure agreement on restructuring terms and should be discouraged, but I believe that those who have bought in the secondary market will find the main objectives of the London Approach and a mutuality of interest as relevant as traditional London-based banks.

- There are also more technical issues which have come to light as the market has begun to develop. There is legal uncertainty concerning the status of trades prior to settlement. Confidentiality of information and the applicability of insider-dealing legislation also need to

be considered. Voting arrangements under sub-participation agreements are another area of uncertainty.

Need for a market-led solution

None of these need block the development of an orderly market in London. In the past it has been suggested that we might seek to prohibit trading in the debt of a company which was the subject of a workout. I must emphasise that we do not see sense in this proposal; neither, I believe, do the majority of the banking community. At the other end of the spectrum is the argument for total freedom of action. This is understandable, but if interpreted literally, could preclude the London Approach itself.

The solution, I believe, is for some form of convention to be drawn up for use when trading the debt of a company which is the subject of a London Approach workout. I am clear it is for the market and *not* the Bank to take the initiative in these areas. Such a convention might include:

- keeping the lead bank informed of all trades during a workout;
- ensuring that buyers of the debt are aware that the company is the subject of a workout and familiarising the buyer with the London Approach if necessary; and
- transferring voting rights only after the trade has been completed.

The aim of these arrangements is not to preclude trading, but to ensure that it does not damage attempts to put together a refinancing. I suspect the market as a whole would also benefit if such a convention increased the willingness of other banks to trade in the market, thus raising liquidity. Standardisation of documentation is another area which could be addressed, helping to reduce transaction costs.

Summing up

Let me draw to a close by summarising our position. Our interest in the development of a secondary debt market in the United Kingdom stems from our long-running involvement in corporate workouts under the framework of principles known as the London Approach. Workouts are changing with the globalisation of financial markets. Larger, internationally diverse groups of lenders will present new challenges. I firmly believe the most effective approach will be some form of international understanding, building in part on the past successes of the London Approach. Such an understanding is likely to take some time in coming to fruition. Meanwhile the London Approach continues to be used as the basis for many workouts here in the United Kingdom.

The development of a debt-trading market in London will also have an impact. We do not seek to prohibit the growth of such a market and we do not have a locus for doing so. We want to see an orderly professional market which will add liquidity to banks' loan portfolios, serve as a useful portfolio management tool and perhaps, when sufficiently developed, act as a guide to levels of provisioning. We want to encourage the market to think for itself of ways to incorporate debt trading into the common sense London Approach framework which has served the lending community and companies alike so well in the past.

Debt trading is undoubtedly here to stay. Agreement among market participants on how to conduct trading within the context of a workout will ensure that the potential problems I have discussed do not materialise and that the advantages which the market can bring will be enjoyed by all. The coming months and years will be challenging for us all and I look forward to continued involvement in the debate.