CURRENT ASPECTS OF UNSECURED LENDING
FINANCIAL RATIOS

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In my experience financial ratios are expressed in agreements as covenants. The lawyer has to draft them. The first observation I make is that lawyers are not businessmen - whatever they may think, and they are not accountants - whatever they may think. We learn a great deal about both in our experience as lawyers but we need a great deal of help in drafting good financial covenants.

It is impossible to produce anything worthwhile if the bank sends down a term sheet saying "Please produce a draft agreement, usual financial covenants". If you are going to produce the sort of useful or meaningful clause that the last two speakers have been talking about you have got to know as much about the business that is borrowing as they have. So a great deal of thought has got to go into it on behalf of the lawyer.

O.K. So he writes it all down and he gets it right. But what has he achieved? It is expressed as a covenant. Covenants can produce actions in damages, but is that really what anybody in this room really thinks a loan agreement is about. Do you go suing for actions in damages because somebody has breached one of these covenants? I don't think so. What I think that covenants are about is possibly monitoring but basically constituting events of default.

Now if you have complicated financial covenants then some of the thoughts we have just heard can produce pretty complicated clauses. You are all very pleased when the thing is all signed up and even more pleased when you get your fees paid and then you leave the deal and get on with another one and after a bit the banker comes back and says "I've got a nasty feeling things aren't working out". And you say "Why?" And he says "Well, I've got a feeling these covenants are not being observed". And then you ask for a bit of information as to why he thinks that and it is not there because all he has got is the annual accounts and these ratios cannot possibly be monitored looking at the annual published statements.

Now if he has got that right he will be asking for a great deal more information than the annual published accounts. I mean in addition to the usual information covenant, one of those vital things, he may be calling for management accounts on a quarterly basis or more. In my experience well run commercial borrowers object strongly to supplying a vast amount of management information like that. They may even have objected long before this in saying "Hell's teeth, we like to run our own business, we don't like the banks running it for us and we are not going to have to go and ask for permission for every single little decision". But O.K. the moral there is to make sure that you can monitor your financial ratios from some available bit of information. But in the end is it really more than an event of default?

You have worked out these complicated ratios which justly tell you that the thing is unstuck. What do you do? Is it maybe just possible, I assume you have got all the information and everybody is co-operative to informally workout the situation, but basically I think you are left with the decision of whether to pull the plug or not. And therefore I do wonder whether one doesn't attach too much importance to financial ratios. I think workable ones, fairly simple ones which you can read straight off a balance sheet, bearing in mind of course that that only comes out once a year and then it may be a few months late, may achieve something. But over the years I have become more and more suspicious about whether they achieve much. They do marvels with a really well run borrower, but a really well run borrower is going to pay the debt back anyway and they never seem to me to achieve very much with the other type of borrower, the one who really needs the money.