CURRENT ASPECTS OF UNSECURED LENDING
NEGATIVE PLEDGES

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I wonder if I could take you out of the courts and back into real life.

Lord Maynard Keynes said that if you owe a bank $100 you have a problem, if you owe a bank $100,000,000 the bank has a problem. The problem of course is the relativity of risk of loss.

By definition, unsecured lending suggests a higher risk of loss and before a banker lends unsecured there are two instantly obvious aspects that he has to consider. First there is the standing of the borrower; the borrower must be of a size and stature to encourage us to believe in his financial integrity, and indeed his willingness, as well as his ability to repay. And secondly, we must be completely satisfied with his future viability in a macro sense and of course his future profitability in particular. Simply, we must do our homework for an unsecured borrowing.

Now that has cut a very long story short but when the banker is satisfied with these two difficult criteria, the lawyers can be called in and usually they draw up loan documentation which takes the nature of a negative pledge.

At the outset I must admit that I am very wary of the term "negative pledge". These days "negative pledge" seems to be a rather generic term which describes something as basic as a few loan covenants in a facility letter, ranging through to the more traditional, separately bound document which can run up to 100 pages: how a banker is supposed to manage a 100 pages of legalese I am not too sure!

However, in both cases the common theme is that a set of ground rules for the borrowing are established and agreed between borrowers and lenders.

Once bankers did this with lovely expressions such as "the facility is provided at the pleasure of the bank" or "the facility is provided on the bank's usual terms and conditions".

Both probably said the same thing: if you want your money, you play by the bank's rules. Now it seems that we say "the facility is provided on the usual negative pledge clauses" (then we send it down to Richard to dream up for us).

If you accept there is a need to set down separate ground rules, I guess the logical question is "what has changed?". I would like to think that the old banking ground rules changed largely because many of the relatively new lending techniques of today don't have any real commercial or legal history, let alone "usual terms and conditions" which have been built up over hundreds of years of commercial and legal precedent.

These new lending techniques arose essentially because banks found that they could not continue to grow their balance sheets to cater for large corporates' needs. And both banks and corporations found there were more efficient ways of raising moneys, particularly through the capital markets, and I think that it is from these origins that negative pledge grew.

Just to put securitisation generally in the context of its considerable impact on bank balance sheets: in international markets direct bank financing in 1986 accounted for about 20 percent compared with about 50 percent a decade before.

But a major spin off from this is, I believe, that banks have moved their direct lending thrust down to less financially secure corporations, to fill the void created by the AAAs (and a few A-s) moving to the capital markets. I know this is simplistic and must be seen in the context of a highly competitive and changing financial environment. However, I think it is fair to say that the lending techniques once reserved for prime names have been offered to lesser corporations, and this approach has even cascaded down to the small one man operation - I might add with very considerable ramifications for banks and their customers alike. Those ramifications range from the new wave of prudential controls imposed on banks, through to the rather imprudent implications of banks extending multi-currency facilities to small borrowers unaware of the vagaries of the FOREX market.

That is another story. I just want to point out that the <u>nature</u> of the negative pledge is now common commercial banking practice in unsecured borrowings. I believe the contractual obligations established by the negative pledge are mandatory today in creating operating ground rules which are agreed by both the borrower and the lender. The worth of this I think is obvious, especially in the context of <u>new</u> techniques being offered to <u>new</u> players.

Time precludes dealing with all the components of a negative pledge but a couple of aspects deserve special comment.

As you know, a banker always looks closely at his repayment sources and his ranking for them. Bankers have always been accused (and I think most unfairly) of lending to those borrowers who don't need to borrow. Usually this is said in the context that banks will only lend against pledged assets. However, I am sure you are all well aware that no bank wants to realise its security.

Consequently I believe that security is only really taken to protect repayment sources; assets being the usual source of income and possession being a strong point at law, I understand.

In contrast, Philip Wood (Law and Practice of International Finance Vol 2) says that the prime functions of the negative pledge are:

(a) to prohibit the allocation of assets to a single secured creditor;

(b) to establish equality between creditors of the same class;

(c) to restrict, indirectly, the incurring of excessive liabilities.

These paraphrases of a rather lengthy expose, highlight the intrinsic worth of the negative pledge to a banker.

These days, when it is most unusual to find a corporation with only one banking relationship, the ability to prohibit, or at least restrict, the leveraging-up of assets is a vital need for a banker lending unsecured.

Establishing an equality of ranking among major creditors is also important.

While on the subject of equality of ranking, I think it is fair to say that the accounting profession has not been too successful in clearly determining who ranks where and maybe at least a negative pledge by one form or another does give some indication of ranking.

Nothing grates more for any lender to find the "last in, first out" principle being applied to companies who least need a "fair weather" financier.

Wood suggests that this function of "establishing equality" through a negative pledge is "more romantic than logical" and I can only assume he is recognising the fact that behind the lenders to a negative pledge arrangement, are people with differing or unequal experience and capabilities.

Obviously the detailed covenants and events of default in a negative pledge are designed to sound warning bells. But the unsecured lender simply cannot rely solely on the various financial ratios and other covenants as the be all and end all.

I think it is incumbent on every unsecured lender to undertake his own individual assessment of the borrowers position. If that includes looking at financial ratios etc. fine, but I think he has got to go a little further than that. He needs to stay very close to the borrower in particular and he has got to keep up to date with developments which affect the borrower in general. Needless to say, the degree to which this is done is dependent very largely on each lending manager's personal experience and capabilities.

I opened by suggesting that in all unsecured lending a banker must look long and hard at the prospective borrower's commercial and financial acumen, his financial viability and above all his integrity. No amount of documentation will protect a bank should the people, the management involved, be found to be lacking - either the borrower in his operation or indeed the banker in his assessment of that operation. No amount of documentation will change the probability of loss although it is probably fair to say that the negative pledge will determine when we can act, and it may determine what amount the bank might recover or lose and when.

When you think about it, the negative pledge records the more obvious or tangible risks and is only as good as the draftsman. No documentation extends to the less obvious or intangible factors and, as always, it can only be as good as the people who sign it on behalf of both the borrower and the bank.

In summary, despite this period of substantial change in the banking world, the fundamentals really have not changed a great deal at all. We still rely entirely on people, not paper.