CURRENT ASPECTS OF UNSECURED LENDING
NEGATIVE PLEDGES

QUESTIONS AND ANSWERS

Comment - Douglas Webb (Rudd Watts & Stone, Wellington):

I want to comment on two matters that have been mentioned here. First of all I want just to suggest a possible explanation for the treatment by the capital markets of negative pledges that Richard has mentioned. I suggest that the explanation may be that when an agent is putting a deal together on an unsecured basis and is selling the paper down on that basis the last thing he wants in six months time is to find that somebody else is also selling paper from that same name on a secured basis. That is the primary interest that the agent has. It is not so much the question of security, not so much the amount of monitoring or preventing various behaviour by the borrower, but primarily, to protect the marketability of the paper.

The second matter I wanted to comment on was something which arose out of Diccon's comments relating to negative pledges. He talked to us about ways in which one could manufacture a negative pledge that came very close to, if not in fact, creating a charge. It struck me when I was listening to that it was a fine exercise but I really wondered if in fact we were successful in doing that - creating an agreement to charge - whether we might in fact trigger other means of debentures given by the same borrower and whether this would be welcomed by the borrower or by our lender clients.

Response - Richard Youard:

There must be a lot of truth in what the speaker just said. If you are dealing with an unsecured loan which is primarily intended to be marketable in the sense that he meant I would be concentrating my criticism on the classic contrast, the straight unsecured, probably syndicated, loan where people stay in for the duration of the loan. I am not sure that principles in the end should differ so much and even in the Euro commercial paper programmes which are now all the rage, you get more sensible negative pledges than you do in the bond market. I think I would stick to my guns although I accept that point as a question of the intention of the bank, if he has got something which he intends to pass around as paper quite soon.

Response - Diccon Loxton:

I agree entirely with the comment that was made on what I was saying. I was constructing a whole house of cards in the end which did not really work to prove it was not worth much, and so establish that if you try and jump across the gap from the philosophy of unsecured lending to secured lending you are back where you started.

On the subject of capital markets issues, I think there is another reason and a justification from the issuer's point of view. If the issuer is a borrower and he is dealing with banks he is dealing with people that he knows and - in a twisted sense - loves and has grown to know over the course of a few years. He has a group of people over whom he can always wield the big stick of relationships and future dealings, if he wants to do something different over the course of the financing. So if for some reason he has got a restrictive negative pledge which stops him virtually giving security to anybody and he comes to a specific instance where he wants to give security, for very good reasons that the banks would be inclined to accept, he can always go to those banks, and wave that big relationship stick. In my experience they generally fall under the pressure of the stick and agree. On the other hand with bondholders he is dealing with people who have absolutely no interest whatsoever in giving any sort of consent which may in any way take away from the value of that paper. They have absolutely no interest in getting together and coming to a meeting and giving the sort of consent required. That is of course assuming that you require the consent of all of the bondholders. You may have a very flexible trust deed in which the trustee is given the power to consent to breaches of the negative pledge but I don't think you will find a trustee on this earth who would be brave enough to give that consent. The difficulty with capital markets negative pledges is their lack of flexibility. The real problem in my experience comes when you have banks entering into the capital markets game in underwriting facilities. There you have an interface between those people who say: "This revolving underwriting facility is really a capital markets transaction. This is what we had for our last A$ bond issue with equity warrants and so this is what we want when we are dealing with you"; and the bankers who say "Well no, we are really banks. This is a disguised banking transaction. This is what we had for our last syndicated loan agreement and this is the sort of negative pledge we want". Occasionally the banks submit to that sort of pressure and have that type of capital markets negative pledge, which as Richard Youard correctly says means very little at all.

Comment - Richard Youard:

Well while you are all waiting to think what to say next, I am not entirely convinced by what Diccon said. There is a lot of truth in it, but the problem is that the lenders in a capital markets thing are not present at the negotiating table. It is

perfectly possible to draft a negative pledge which means something which is a bit more than the ones people get at the moment, but the bondholders are not there. Some kindly investment banker is giving up his valuable time to negotiate the terms on his behalf and he just doesn't seem particularly inspired to ask for something that means something. It would be cynical to suggest that there was any kind of ulterior motive behind it!

Comment - Don Argus:

I would like to reinforce Richard's comments. I believe in capital markets issues, your negative pledges really aren't worth the paper they are written on. I think of the way we went with Bond on the brewing deal where they went to the junkbond market in the States. I think you have to realise that to a large degree the junkbond market is driven by price. Where you have got so many different instruments in a market, the investor will not be particularly interested in the fine detail of what is said in the documentation between the lender or anyone else.

Comment - Richard Youard:

One or two points were made this morning which seem to me to emphasise the complexity of agreements which we are all writing now. One thing that I have learnt over the years is to make the thing as simple as possible. Of course that means incurring extra risk because the complications that are introduced are invariably to plug one more loophole or to tailor-make the thing to the ultimate degree. But we do get carried away. I have found too many occasions when we simply can't understand after the event what the hell it is that we have written. It was brilliant stuff at the time but we can't actually do anything with it. And the thing that finally made me lose my nerve was when a colleague of mine was working in London on some off balance sheet financing and everybody involved was an expert at their game and it started off at a mere 80 pages and it ended up with 240. On the day of the signing the partner of mine who was responsible for this said "Thank god that banker 'X' was at the final negotiating session yesterday because I realised that I had now lost control of the whole thing. I no longer understood what we were doing". So I thought well that is at least honest: thank god banker "X" was there. After the signing I met banker "X" and he said "Thank god your colleague was there". And this is absolutely true - between us we had created a monster which we no longer understood and could no longer control. Absolutely mad.