

## **Development in Financial Ratios in Corporate Borrowing Documentation**

### **Questions & Answers**

DERMOT ROSS: Dermot Ross from Chapman Tripp in Auckland. Yes, Richard, the question is one you know already, and that is at what stage can you actually say that a breach of a ratio has in fact occurred? I'm thinking not just the balance sheet ratios which traditionally are obliged to be maintained at all times, in other words on a daily basis, but also the profit and loss ratios where you look at them once, twice or four times a year. Is it the time when the management or the directors of the borrower realise they're going to be in breach; is it the time when they actually formally meet to resolve to devalue an asset, for example.

Is it the time when they produce the management accounts, say, 20 or 30 days after month end or the actual compliance certificate which your lender tends to require? It's pretty hard to advise on those issues, in my experience, but I'd like to hear what the panel think, particularly you, Richard Henshall. Thank you.

RICHARD HENSHALL: I suppose the answer is that's why I always like to have potential event of defaults rather than just events of defaults in loan documents, because the reality is you often see a default coming, you will know that the company is not going to make a ratio, but until they have actually failed to make it, unless you have a concept like a potential event of default in your loan document, you have to sit there. I mean, obviously, you can go and talk to the company, but if they want to be difficult, you're stuck.

DERMOT ROSS: No, fair enough. That gives you protection in the situation where it's a revolving facility and you don't wish to lend any more, but it's a little bit harder to try to take remedial action like acceleration, or requiring discussions et cetera, where it's only just a potential event of default and there's no concrete accounts you can look at. I think it's just a perennial problem, really.

PETER HEDGE: I must admit from my experience, I would suggest again that it gets back to a documentation issue at the outset, and an understanding the basis upon which the loan is being based at the outset, because if the value of an asset is that integral to the decision, and the risk being taken by the financier, you would expect the document to be quite prescriptive about the fact that an independent valuer must be engaged by this state every year. The report must be provided by this date, etcetera, etcetera, and to me it really gets down to being quite prescriptive about the particular basis and risk they're trying to manage. Now, if they're not actually worried about the value of the building, then the valuation of it becomes irrelevant. Would you agree?

KEITH BARRY: Yes, well, what we're talking about, I think that's absolutely right. This is a fundamental negotiating point in any loan document between any borrower and lender is when exactly your potential event - how far in advance of an actual payment default you can actually get an indication of a problem and when can you act, and it depends a great deal on the negotiating power of a borrower.

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The further down the scale you get, the higher the ratio hurdles that you're going to be facing and one of the tricks of a banker would be to push up the gearing ratio or a debt service cover ratio to a level where it has an indication.

Typically a debt service cover ratio to a level of, say, 1.5 or even higher so that the lender gets an indication early on in the piece, and then he has to try and negotiate some kind of default trigger before the payment default.

RICHARD HENSHALL: The other thing is just a practical point. If the borrower doesn't want to tell you, it's very hard to get it out of him until the end of the period that's specified in the documents when he has to give you the compliance certificate. So you can be in a situation where you'd know that they are stuffed, but if they have got, under the document, if they've got 30 days to give you that compliance certificate then really, you just have to sit there till on the 30th day, they actually admit it.

DERMOT ROSS: That tends to be the advice that I've had to give my bank clients, over the years, I have to say.

MR MARK GROLMAN: From Deutsche Bank. I thought I should help my client out. I think that Dermot asked quite a technical question. You've responded, all of you on the panel, in a rather commercial way. May I suggest that the technical answer to the technical question that Dermot asked is that the event of default occurs as at the balance date as at which the accounts are drawn up. The problem for bankers is they always find out too late, because they find out after the event, that the event of default has occurred, and it goes back to what the speaker said, about the fact that the ratios are mostly a historical snapshot ratio instead of ongoing ratios and there's a tremendous tension there, and I don't think it's easily soluble except by partnership between lenders and borrowers.

PETER HEDGE: I was going to say, and of course that recognition of the timing arguably is considered when determining the buffer that you put in to the ratio. I mean, this is an issue, for example, that regulators deal with all the time in relation to their capital adequacy and solvency ratios and so they stipulate when the accounts must be available, and of course they build in there a buffer, so that there's more than enough time once they know there's a problem to try and do something about it, if they choose to.