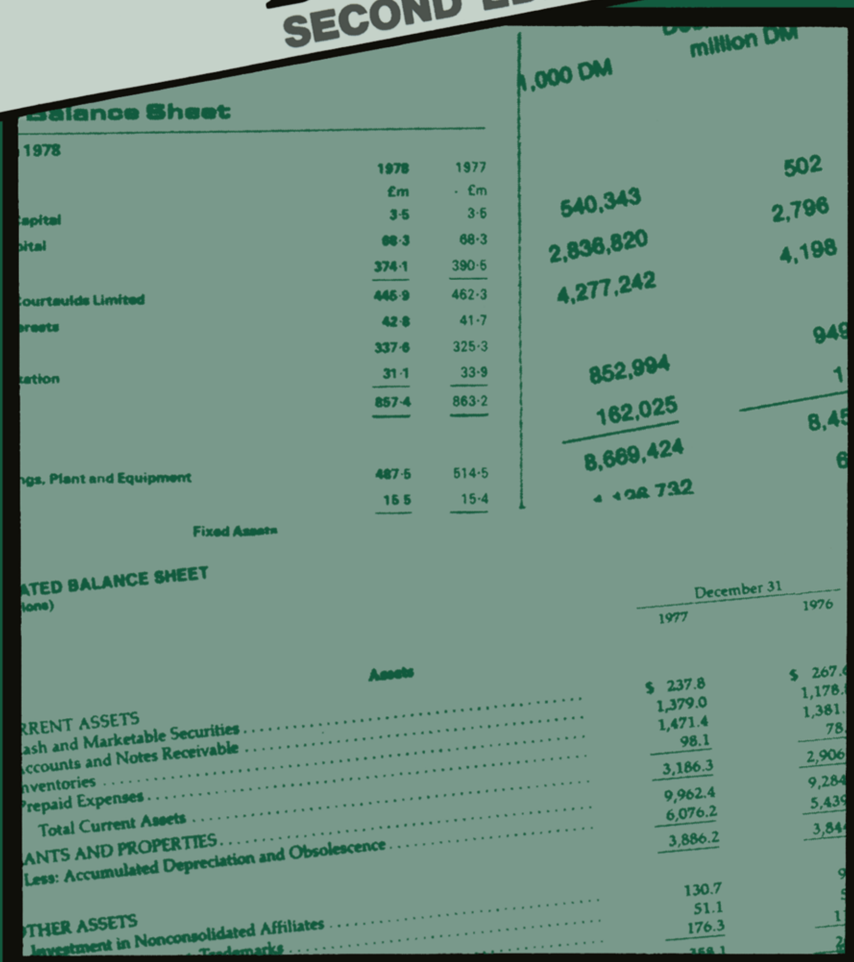
T.H. DONALDSON

LENDING IN INTERNATIONAL COMMERCIAL BANKING

SECOND EDITION



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GENERAL EDITOR: STEVEN I. DAVIS

LENDING IN INTERNATIONAL COMMERCIAL BANKING

INTERNATIONAL BANKING SERIES

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Lending in International Commercial Banking

Second Edition

T. H. Donaldson, FCIB

Foreword by Steven I. Davis

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Contents

Editor's Foreword

The internationalisation of banking since the 1970s has been one of the most intriguing trends in the financial industry since the Second World War. Whether one measures it by the volume of overseas lending, the modification of traditional banking tenets, or changes in physical structures, it is a truly revolutionary development comparable, for example, to the appearance of international merchant banking in the Renaissance period and the nineteenth-century growth of commercial banks financing trade with the developing countries of the time.

This phenomenon has not, however, been matched by a comparable development in banking literature. While a variety of books have described the theory and structures of the new Euromarkets and the function of the traditional foreign exchange markets, relatively few books have been written about how bankers actually manage their new international responsibilities. Even more unique are volumes written by experienced, practising bankers about how they deal with the practical problems and issues they face.

The purpose of the Macmillan series in International Banking is to fill at least a portion of this gap. While not specifically designed as a series of textbooks, in that it is oriented towards the management issues of international banking, the series does explain how the basic international banking functions are performed, both in theory and in practice. It will hopefully, therefore, serve as a useful reference point for students of banking; individuals who are entering the field of international banking, and outside observers such as customers and academicians who would like to know more about how bankers run their international business.

In view of the fundamental importance of lending to an international bank's image, as well as its profit and loss statement, Mr Donaldson's book is a key element in this series. Drawing on his own extensive experience as well as that of a number of other bankers he has interviewed, Mr Donaldson explains in detail how banks analyse international credits and how such lending differs from the domestic activity of these banks. He also explores the problems encountered in the documentation and syndication of international loans and analyses the loss record and relative profitability of international lending using the limited data available at present.

Mr Donaldson's experience in international lending gives him some unique qualifications in his role as author. An Englishman with 20 years of banking experience, he has spent most of his career with the London branch of an American bank which is generally acknowledged as one of the most highly regarded leaders in the international banking sector. Equally useful has been his spread of responsibilities, which have included not only that of senior officer responsible for a variety of multinational corporate accounts, but also, in recent years, that of senior credit officer in the branch with staff responsibility for the quality of the bank's credits and its lending procedures.

I am most grateful to Mr Donaldson for taking the time and effort to produce this essential element in the Macmillan series. Should the reader be interested in how the lending function meshes with inter-bank lending and other operations usually associated with the money dealing function, he is referred to Nigel Hudson's book *Money and Exchange Dealing in International Banking*. Also, the asset management function as a whole is described from the standpoint of the senior management of an international bank in another volume in the series, *The Management of International Banks*.

1979 STEVEN I. DAVIS

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My thanks are due to a number of my colleagues at branches of Morgan Guaranty who provided me with written material on banking in their countries, and introduction to bankers in London who could talk in more detail. Also those who read and commented on various chapters of the book and made suggestions which greatly improved them.

My thanks also to the numerous bankers who talked to me willingly and at length about the way their banks operate. Anything that is original in this book stems from these interviews, and I am profoundly grateful.

My thanks to my wife, and to my secretary, Mrs Sheila Parsons, who shared the typing; and again to my wife and to my children for putting up with me while I wrote the book.

Morgan Guaranty Trust has provided me with the experience on which much of the book was based; but the views in the book are mine and mine alone.

1979 T. H. DONALDSON

1 Introduction

LENDING BY COMMERCIAL BANKS

Bank lending is a function of commercial banks. However, in the early to mid-1980s, new forms of borrowing which combine some aspects of securities with some aspects of lending (the securitisation of lending) have begun to blur the distinction between commercial and investment banking, at least at the margin. The enforcement by law of the distinction in the United States is under attack, and its existence in practice in the UK (and some other countries) has become less clear cut. Nevertheless, the theoretical differences are clear, even when in practice both concepts are covered by one organisation; and so are the implications for the structure of the balance sheet, the internal organisation, type of management and of service offered.

Commercial banks take deposits many times their capital and relend at a narrow margin above cost, which is turned into a satisfactory return on equity by the substantial gearing. This has always involved holding unused facilities available; a major impact of securitisation is to multiply the importance of committed but unused lending facilities. An investment bank does little or no lending, but mobilises funds of others by means of underwriting, private placements, etc. While it may take substantial risks - particularly in underwriting - they are short term, with no continuing massive gearing. Indeed, their nature makes such gearing inappropriate.

Because a commercial bank is highly geared, the loss of only 5 to 10 per cent of its loan portfolio can wipe out its capital. Because depositors who provide the funds receive no share of profits, such a risk is unacceptable. But low risks earn a low profit margin, and this - since banks do not share in borrowers' profits - in turn helps to condition the attitude to acceptable risks.

Naturally different banks in many countries will take varying specific approaches to lending. Nevertheless, the attitude of all to risk and risk control is conditioned by the fact that commercial banks are highly geared lenders.

To remain highly geared and to earn a sound return on capital despite a low return on each individual asset requires external confidence. A bank thought to have a poor loan portfolio may lose deposits; without deposits it cannot continue to fund its loans and meet its commitments. It is thus vital for any bank to have an approach to lending which ensures a sound portfolio. While most banks provide insufficient information for external judgement, the market develops a feel for the quality of loan management. (This, probably more than any other factor, conditions the view that is taken of banks by competitors and large depositors.)

International lending is more complicated, with wider considerations affecting the viability of the borrower and the ability to recover the loan. Conversely, however, some international lending is more genuinely self-liquidating (as in commodity and acceptance financing) or carries the guarantee of a first class government or government agency making it as safe as any domestic loan. But the attitude to international risks reflects the same underlying factors.

A HISTORY OF INTERNATIONAL LENDING

International lending is not new. Steven I. Davis, in his book *The Eurobank*, describes periods since the Middle Ages when 'factors such as the growth of international trade and investment produced a variety of new banking institutions whose objectives, lending practices, market environment, sponsorship and structure were not at all dissimilar to the Euro-banks established in the 1960s and 1970s'. He describes foreign lending and some of the banks doing it from the fifteenth and sixteenth centuries.

However, the continuous history of international lending, by institutions still active, began in the late eighteenth century with UK merchant banks, who came into lending from merchanting almost as a sideline. As early as the Napoleonic Wars and throughout the nineteenth and early twentieth centuries, merchant banks were lending to foreign governments. They also financed trade in substantial amounts, largely by means of acceptances.

The strength of sterling and of the UK economy helped the establishment of a major market in acceptances in London, financing offshore trade. In addition, in the 1830s the first British overseas banks were established to provide banking facilities within the colonies and to finance colonial trade. These soon extended into areas where Europe had strong economic interests, such as Egypt, Latin America or Turkey. Other countries followed suit and the development of overseas banks featured in the struggle for spheres of influence throughout the world.

However, perhaps the most rapid growth in international lending was from Europe to various American States and for private investment and trade with the US. Many UK merchant banks and British-owned US banks were established for this purpose. Although there were five British-owned banks in California by the early 1860s, New York was the first American centre to establish a presence in international banking. However, New York acted as the nexus for a capital inflow, while London's outflow according to one source was equal to more than 10 per cent of Britain's Gross National Product (GNP) in some years before the First World War. This different function as a financial centre persisted broadly until after the First World War when New York first became an exporter of capital and threatened London's predominance in international banking.

The management of British overseas banks was usually in London, controlling branches overseas. Some other countries followed a similar approach, but the Germans preferred subsidiaries with majority control. Direct representation overseas provided local knowledge and experience essential for credit analysis, since probably the only other source of information came from the handling of collection business. The main drawback was the difficulty of control, with slow communications making current contact from head office impossible. Numerous banks suffered losses because of incompetent or dishonest local management. Another major problem was political upheaval, causing expropriation or pressure to lend to a government which might subsequently be overturned and the loan repudiated.

Throughout the nineteenth century international banks were established on the flimsiest grounds with little experienced management or capital; many either never did any business or were liquidated within a few years. However, some established themselves as sound and profitable operations and – despite the occasional substantial loss – began to develop knowledge, procedures and high standing.

Economic nationalism – always a problem – intensified before and even more after the First World War. In 1909 the Californian Banking Act prohibited branches of foreign banks; several established British banks were taken over by American banks. In 1919 Congress passed a number of measures, including the Edge Act, to help US banks compete with foreign banks. In the 1920s and 1930s economic nationalism was intensified by severe economic problems and overseas banks began to amalgamate in order to compete effectively with banks of other nationalities and local banks strongly supported by government.

Also in this period US banks first started to move overseas aggressively rather than defensively, through branches, joint ventures and minority shareholdings in local banks. This was mostly unsuccessful; many overseas ventures were closed down before 1939, often with heavy losses reflecting lack of overseas experience and access to credit information.

The First World War weakened the thrust of the German overseas banks, partly by eliminating German colonies but also through boycotts arising from the hostilities. This process was completed by the Second World War.

The Second World War also accelerated the decline of sterling and the growth of the dollar as world currencies. The weakness of sterling led to gradually more severe exchange controls and restrictions on capital outflows which reduced the City's strength as an international centre, while the strength of the dollar made the US a major exporter of capital and made its banks think internationally. A few already had branches in major centres such as London, Paris and Brussels and in Latin America, but for the period after the Second World War most American international lending was from New York.

THE EUROCURRENCY MARKET

From the middle 1950s the US balance of payments swung into continuing deficit, pumping dollars into the hands of non-residents. Secondly, in 1957 the Bank of England imposed a major reduction in the availability of sterling for international trade. Paul Einzig dates the birth of the eurodollar market from this, as do many other writers. Some suggest the Bank deliberately encouraged dollar finance to protect the City's international standing without exposing sterling. Another story is that the Russians, reluctant to deposit their dollars in the United States, started the eurodollar market. The Bank of London & South America (now part of Lloyds Bank) and its then chairman, Sir George Bolton, are generally recognised as the first commercial bankers actively to lend eurodollars.

By the early 1960s eurodollar lending was a feature of the London market. It grew explosively following the introduction of Interest Equalisation Tax and other measures by President Kennedy (and later President Johnson) to stem the outflow of capital. Initially, because the sources of funds were short term, lending was also short term. However, as the US measures began to bite, US companies started to borrow medium term off-shore. At first even American banks were reluctant to commit themselves, for fear that the eurodollar was a temporary phenomenon. The US credit crunches of 1966 and 1969–70 helped correct this; the eurodollar market was a major source of funds and it probably supported domestic funding as much as the other way around. Nevertheless, the more conservative banks remained cautious both on maturities and their total medium term lending.

By the early 1970s these fears had virtually disappeared. They returned in 1974, following the Herstatt and Franklin National Bank crises, but more as fears about the availability or cost of funds to specific banks. There was a marked disinclination to lend to consortia on assumptions of external support rather than their own standing. The Bank of England responded by obtaining from all shareholders of London consortia letters amounting to guarantees of support. The fact that shareholders did support several consortia in trouble also helped but the concern, although reduced, remained for some years.

Some banks with a strong base in local currency protected themselves by establishing reciprocal/standby borrowing facilities with major American banks. By the early mid-1980s, a growing market in Floating Rate Notes (FRNS) – subordinated or even perpetual to qualify as primary capital – reduced the importance of reciprocal facilities; as did NIFs, RUFs, and MOFs (to use the most common of a variety of names of facilities to borrow in various ways, but backed up by a bank commitment to lend) and interest rate and currency swaps. American and other banks have also tapped various markets in currencies such as Deutsche mark, Swiss franc, Japanese yen, sterling and ECU (European Currency Unit) to match their lending in these currencies. The process seems likely to continue as more countries deregulate their capital and lending markets.

THE CHANGING NATURE OF EURODOLLAR LENDING

Prior to the 1969–70 credit crunch in the United States, eurodollar lending had been largely to companies, mainly American, and by single banks in amounts ranging from under $1 million to exceptionally, $50 million. After 1970, corporate demand slackened allowing project and balance of payments lending to governmental borrowers to increase quite sharply. The growing size of these loans and indeed of the few corporate loans made eurodollar syndication a major feature. A rush of new banks into London intensified competition so that by 1973 margins and fees were forced down to unattractive levels.

There was some doubt as to the analytical capacity, credit judgement and standards of some of the new banks in face of competitive pressures. The 1973-4 crises and the subsequent problems (the fringe bank and property crises in the UK, the Real Estate Investment Trusts, US National and Franklin National in the United States) allowed substantial recovery in both margins and credit standards.There was possibly some over-reaction and in late 1974 there were only two or three major banks actively syndicating large loans. The pendulum swung again, despite the residual worries of many banks; margins, (see glossary) after rising from ½ per cent per annum to 1¼ per cent for the best names (and more than 2 per cent for weaker names) dropped back gradually under increasing pressure. By mid-1977 they were down to ⅞ per cent and by late 1977 ⅝ per cent for the first year or three of a seven-year facility.This pressure continued and intensified, with only occasional minor relief, until the time of writing (Spring 1987). The problems of Latin America and other lesser developed countries, highlighted by the Mexican crisis of 1982, caused margins to increase sharply for obviously weak credits, but if anything this intensified the pressure on margins for sound credits. By 1984–5. margins of ¼ per cent for up to five years were common and some borrowers achieved as little as ⅛ per cent for quite long periods. The difficulty of making a profit at these levels has undoubtedly hastened the trend to securitisation and a feverish search for new products which carried a higher return. However, competitive pressures were so great that as soon as each new product lost its novelty value, returns were quickly eroded. The impact of these competitive pressures on credit standards became very worrying, particularly as banks' capital ratios had been weakening for the last decade.

LOCAL CURRENCY LENDING BY FOREIGN BANKS

From the early 1960s the number of foreign branches interested in local currency lending grew rapidly. This was most marked in Britain, where the introduction of Competition and Credit Control in 1971 opened up the domestic market to many foreign banks who had come here for other reasons.

Despite some losses in property in the mid-1970s (and more generally in the early 1980s), this successful policy has spurred the British banks to respond at home and overseas. On a smaller scale, a similar invasion took place in most of Western Europe – with even the most tightly restricted markets opening up – and in Japan; after a slow start, the biggest invasion of all was into the United States with mixed results.

Until the early 1970s the major expansion of lending from overseas branches came from the American banks. Towards the end of the 1960s the British clearing banks (who had not previously had a large overseas business) began to take control of British overseas banks (with large networks in traditional areas) and/or to expand their own operations directly. They moved into New York through branches and acquisitions and into California by acquisition, meeting the Japanese coming from the opposite direction. They were then joined by banks of many nationalities, by consortia, and in all parts of the United States. Elsewhere, the German banks re-established themselves in London, many German and Scandinavian banks (in particular) opened in Luxembourg, and even quite small European banks became more internationally minded.

USE OF SECURITIES IN NEW FORMS OF LENDING

In the late 1970s the bond market introduced the floating rate note (FRN); this was a normal bond except that its interest, instead of being fixed, was set periodically at a margin over LIBOR. Initially the margin was ¼ per cent and the LIBOR six months; with time, margins became squeezed and the borrower was given greater choice of period. At first, the main issuers were banks, often on a subordinated basis; these FRNs enabled non-dollar banks in particular to match their floating rate loans with comparable liabilities. They also gave them quasi-capital in a currency which matched many of their loans. As regulatory requirements on capital became tighter, the form of the notes changed to meet them. Wrinkles introduced in early 1986 include perpetual notes and notes which automatically convert to preference shares if the bank goes into liquidation; some have both features. At the same time FRNs became available against other interest benchmarks (US Treasury Bills, for instance, or CDs) and in other currencies, both domestic and euro.

Banks were never the only issuers; governments and prime corporates gradually became equally important. However, although the FRNs were sold as bonds, in practice banks bought many of them. They thus gave an attractive alternative to the traditional bank syndicated loan to borrower and lender. However, since not all buyers were banks, they also opened up new sources for the borrowers, and introduced less sophisticated investors to the market.

Despite their advantages, FRNs were less flexible in some ways than bank loans. The market therefore introduced new facilities, under which the borrower can issue notes at auction, with a group of banks underwriting the ability to sell them at a minimum rate. While many banks introduced variants with their own name, the facilities are most often referred to as RUFs (revolving underwriting facilities) where an investment bank handles the issuance or NIFs (note issuance facilities) where issuance is through a tender panel of commercial banks or their merchant banking subsidiaries. While banks fight fiercely for investment banking profits from arranging the facility and selling the notes, the commercial banks act as insurers and bear the main credit risk; they alone undertake to lend at a fixed spread when the market will not. In practice, however, the borrowers expect – as long as they are healthy – to sell notes at a lower cost than banks can afford.

Moreover, documentation on NIFs and RUFs is in early 1987 still evolving. There are some doubts as to who bears the ultimate credit risk in certain circumstances, which worries the Bank of England among others. There is also little or nothing in the way of covenants or other protection to cover the risks of a medium term commitment. This may be just acceptable for the best corporate, bank and sovereign borrowers who initially were the main users; as competition opens the instruments to a wider range of borrower, there will have to be some tightening up. Nevertheless, the intermediate stage – where the banks accept all or most of the risks of a bank loan for a derisory fee and with little or none of the protection they would expect in a loan – is worrying. Already, major banks are declining to underwrite the notes unless they can take a large share of the investment banking fees. As a result, many facilities are largely underwritten by weaker banks which would be most likely to have difficulty in meeting their commitment in a market crisis. Moreover, no NIF borrower has yet had to restructure its debt; defining the position of the various parties and pulling them together when the first restructuring happens will be a severe test – with damaging repercussions following failure.

Against this background NIFs (to use a generic term) have evolved in two directions. One (the MOF, or multiple option facility) keeps the underlying NIF structure but adds to it the ability (uncommitted) to borrow in a number of different ways, and even in different markets. For items such as acceptances there may even be a separate tender panel. The borrower thus has maximum flexibility to choose his borrowing instrument, currency and period, but still has the certainty of borrowing at a maximum rate in (usually) dollars. He also can choose not to borrow and just pay the underwriting fee.

The other (or eurocommercial paper) evolution is so called because it drops the underwriting commitment altogether. Borrowers simply sell notes at the best possible rate, but with no guarantee of continued availability or of any particular rate. Borrowers are either confident of their ability to borrow at all times; or of their ability to repay debt rapidly if they need to; or have other committed facilities to which they are prepared to allocate this extra function. The British government approved the issue of sterling commercial paper in the spring of 1986.

In some cases, the two evolutions have combined, with MOFs which carry a larger uncommitted facility and a smaller committed one.

Other aspects of securitisation include the growing tendency for banks to sell loans, with consequent adjustments to documentation to make this easier and to eliminate credit risk or tax problems; the growing tendency (long established in the US but spreading to the euromarkets only in the mid-1980s) to package together mortgages and perhaps other types of retail loan and sell them either as a bank loan, bond or a hybrid; and swaps.

Swaps can be either interest rate swaps or currency swaps, or both. While not themselves a loan or borrowing, they enable a borrower to transform the nature of his loan (fixed rate into floating, dollars into sterling, fixed rate Swiss francs into floating rate Deutsche mark.) This allows borrowers to use a favourable image in one market to tap markets to which they would otherwise have no access. It also enables them to cover risks which previously they could not, and which were therefore unacceptable.

The section cannot give a complete catalogue of all forms of securitisation, if only because they are developing so rapidly that any such catalogue is out of date within days. The point, however, is that it is part of a process (deregulation is another part) which is blurring the distinction between investment and commercial banking; which is increasing the already extreme competitive pressure on bank lending, and is spreading that pressure to previously more protected areas; which is allowing commercial banks to fight back in some areas (such as mortgages in the UK) against interloping competitors; and which finally is reducing some risks, and protecting against others, but only at the cost of introducing new risks. The new ones may (or may not) turn out to be less serious than the old; they are certainly, in the early stages of the process, less clearly recognised and less understood, and in many cases as a consequence inadequately compensated.

THE NATURE AND BACKGROUND OF INTERNATIONAL BANKS

There are very few purely international banks and even those have a home base. Similarly, almost all banks handle some international business for their customers. There are thus many markets for international lending, with the eurocurrencies a major market in their own right.

It may be a help in understanding the problems to sketch in a few of the main points of the banking systems of key countries and their international development. This is not a comprehensive survey; the purpose is to highlight the different backgrounds from which international banks have to work together.

The US has approximately 14,000 commercial banks, subject to at least one, and usually two, out of three regulatory agencies – the Comptroller of the Currency, the Federal Reserve and the Superintendent of Banks of each state. All three review lending practices, enforce legal limits on amounts lent to any one borrower and restrict other activities. All perform regular examinations of banks' loans, credit controls, and accounting procedures.

Secured lending is less common in the US than in most other domestic markets, partly reflecting greater availability of information, partly because US law required careful policing of collateral. These factors require sophisticated analysis and encourage medium term lending Each state has different regulations as to branches, from Illinois' single branch to California's state-wide branching.

Among many other changes, pressure on single-state rules has already led to some regional banks being permitted; this seems likely to expand, perhaps eventually to include nationwide banking.

A few large money centre banks have had an international presence in some cases since before the First World War. A second group of large and medium sized banks opened branches in London in the 1960s and have extended their branch network into Europe and in some cases the Far East, Africa and Latin America.This was followed by something of a rush of medium sized regional banks, mostly opening initially in London but some going to other areas as well. Many were following their major corporate customers or competitors, although the growth of the eurodollar market also influenced a number.

The big four English clearing banks have been joined by the Cooperative Bank, and by Citibank of the US and Standard Chartered; they have lost Williams & Glyns by merger with the Royal Bank of Scotland. The big eight (four English and four Scottish) have over 15,000 branches between them and are beginning to face more competition in their retail as well as their wholesale business. The Banking Act 1979 for the first time formalised the Bank of England's regulatory duties and established the categories of recognised bank and licensed deposit taker. The workings of this are under review following the Johnson Matthey Bankers *debâcle*, and may also be affected by the trend towards conglomeration in financial services. The Bank of England, however, remains committed to a more flexible and informal approach to regulation than the Americans in particular, and than most others in general.

Lending against mortgages on fixed assets is quite common, but there is no easy way of taking a fixed charge on assets such as debtors or inventory. The floating charge (which does not seem to have an exact equivalent elsewhere), suffers from a number of disadvantages (T.H. Donaldson, *Institute of Bankers Journal*, February and June 1977) but has the advantages of simplicity and does not hamper day to day operations. Although the UK is second only to the US in the information available, reliance on the floating charge appears to have slowed the development of credit analysis.

The traditional separation between clearing banks and merchant banks broke down in the early 1980s. By mid-1985, all the big four had either established or acquired a merchant banking operation, and most were expanding into stockbroking and/or jobbing in preparation for the opening up of these markets ('the Big Bang').

Only two overseas banks remain independent, the Standard &

Chartered Bank (for which Lloyds Bank bid in spring 1986. While the bid was initially unsuccessful, developments in early 1987 leave open the possibility of a second try), and the Hong Kong & Shanghai Bank (while not strictly a British bank, it is British in origin and outlook). All have seen their branch networks become less reliable sources of profits with the decline of sterling and the rise of economic nationalism. The eurodollar market gave them the perfect opportunity to build anew, while their spread of interests still provided a stable base. Their historical connections provide continuing business and they have become active providers of eurocurrency finance, with important syndication and project loan activities.

The remaining overseas banks have either been absorbed into clearing banks or acquired by other banks. The clearing banks have all expanded into the US – by acquisition, setting up branches, or both (although in early 1986 two announced the sale of their Californian subsidiaries). They are also expanding in various ways in Europe, and other parts of the world; Barclays and Lloyds through absorption of former overseas banks have a wider representation than the other two. Midland (after a period when it operated overseas mainly through consortia) switched to operating more directly; its problems with Crocker (now sold) reflected this change.

Despite their long history British merchant banks are only minor lending banks. They are money mobilisers rather than intermediators. Their traditional acceptance business involves international lending, but their banking departments are small. Some made substantial loans in the early 1970s, particularly in syndicates they managed, and built up balance sheets to a level appropriate to commercial banks. After a period when size seemed important, they returned to concentrating on flexibility and imagination, but are again, in 1986, trying to strengthen their capital bases, this time to compete with foreign investment more than commercial banks.

In Germany the big three commercial banks and the regional and other commercial private banks (about 300 of them with about 5,000 branches) are major holders of corporate equities. One source estimates that over 60 per cent of German industry is effectively controlled by the banks; there is a long list of major companies where one bank has more than 25 per cent of the equity. Commercial banks face increasingly active competition from saving banks and central Giro institutions, industrial and agricultural cooperatives, private and public mortgage banks and specialist shipping banks. The emphasis of German bank lending has traditionally been short term but medium term is of increasing importance.

German accounting rules are formalistic and German banks rely to a considerable extent on mortgage security. Presumably the banks with equity holdings have all the information they need, but their dominance makes it harder for other banks to get information. The German banks evince a considerable dislike of external competition and an almost monopolistic attitude to foreign banks. The heavy equity holdings reflect the lack of an active stock exchange and of equity investment by insurance companies. The Bundesbank's supervision includes the right to send inspectors in and a requirement for all loans above 1 million Deutschemarks to be reported monthly. Each bank then receives a summary of the borrowing of each of its customers.

In the mid-1970s German banks again became interested in international lending, on the back of a strong currency, an economy which is export oriented and customers who are more active in overseas investment. The reluctance of the German authorities to see the Deutsche mark as a reserve currency had prevented the establishment of an international market in Germany. However, German subsidiaries in Luxembourg are active in eurocurrency lending and branches are opening in London and other financial centres. In 1984–5, the German stock markets became more active and German banks, led by the Deutsch Bank, began to encourage German companies to go public. In late 1985, the Bundesbank opened up the Deutsche mark securities markets to international competition, and new instruments. The impact of these two changes will not be fully visible for some years.

France shares with Germany the lack of strong equity markets or institutional investors, but all major commercial banks are nationalised. France's banques de dépôt and banques d'affaire approximate to commercial and investment banks respectively, although banques de dépôt have been able to lend medium term only since 1966. The Service Central des Risques of the Banque de France obtains information on lending by each bank to each borrower and distributes consolidated information to the banks. The Commission de Controle des Banques has investigative and disciplinary powers and sets banking regulations. Despite efforts to improve disclosure, few companies provide consolidated figures and financial information is generally not of a high standard. Bank lending is mainly short term, often secured, and substantially by discounting two-name paper. Directly or through various institutions the government is the major source of medium to longer term debt.

French banks have strong colonial connections. They were among the first to open in London and are still well represented there. They have responded less actively than the British banks to the growth of the euromarkets and the opportunity to diversify their lending base, at least partly because of Banque de France restrictions. Nevertheless, in areas involving French economic interests they are active and competitive. Even the French authorities began to relax their tight control in the late 1985, a process which has accelerated since the election of Jacques Chirac as prime minister.

Dutch banking is probably closer to the Anglo-Saxon approach with a well developed stock exchange and other financial institutions and with bankers less inclined to interfere in management. Its two major commercial banks (the results of mergers in the late 1960s) and a number of smaller banks compete with the growing agricultural or industrial cooperative banks. The Giro system is also active and competitive. The central bank traditionally exercises control flexibly and informally but, under the spur of legislation, has been moving towards a more precise approach. Commercial bank lending is mainly short term, although medium term lending is increasing. Dutch banks have a long record of international involvement; indeed Amsterdam was probably the main international centre before the Napoleonic Wars.

Italy has much more in common with French banking, but control is of a more party political nature. Several major banks and some lesser ones are government-owned through Istituto Ricostruzione Italiano (IRI). Commercial banks usually lend for periods of under one year, although a few banks have specially authorised departments for longer term lending, which along with equity investment remains primarily the function of specialist government institutions. Although the banks do not control industry, IRI often does, and both industry and banks are managed by appointees of the Christian Democrats. With no strong auditing profession, with a heavy emphasis on tax and consolidation very rare, published balance sheets are unreliable and lending is on name or against security. Italian banks are well represented in London, New York and Paris but otherwise are not particularly strong internationally.

In Belgium industry and the banks are dominated by the holding companies whose historical importance predates the creation of the Belgian state. The capital market is small and controlled by government institutions. The government credit institutions provide medium and long term capital directly, or by subsidised discounting of bank debt. Other institutions provide equity and finance for local authorities. Société Général de Banque and Banque Bruxelles Lambert each have more than 1,000 branches and Kredietbank has about 650. Despite the dominance of government in medium-term lending, Belgian banks operate under few restrictions and there is no discrimination against foreign companies by the government institutions. Belgian disclosure is poor and clouded by the mass of cross holdings reflecting the holding company set-up.

The Japanese banking system has three main segments, the nine 'City' banks which are among the world's largest, the 65-odd regional banks, which are smaller but still substantial, and specialist banks such as the Long Term Credit Bank. The City banks, as part of the major Zaibatsu, or commercial families, are closely tied to the major trading companies and some industrial comnpanies. The banks, like industry, are closely controlled by government, domestically and internationally.

Consolidated figures are not usual, and creditworthiness depends on links with a Zaibatsu, or status as part of Japan Inc. Unfortunately, membership or otherwise of Japan Inc. is flexible and unofficial, so local knowledge is essential.

Japanese, like German, banks only returned to a broad international presence in the early to-mid 1970s. Their initial thrust into the eurocurrency market in 1972–3 involved cutting margins and going for a big presence fast. This over-enthusiasm caused a 'Japanese premium' as they rapidly filled up their lines with other banks. They probably also ended up with an undesirable proportion of low earning/high risk loans. The Japanese authorities, concerned about the premium and about possible losses and reacting to the 1973-4 oil crisis, compelled them to cut back sharply. They began to expand again in the late 1970s, although at first cautiously, and by the mid-1980s were a major force in the markets. In 1985 their international lending was larger than that of US banks.

In Switzerland there is no clear legal definition of banking or limitation on business a bank can do, but banks soliciting deposits from the public require authorisation from the Federal Banking Commission. The Commission imposes mimimum liquidity ratios and reserves, decides which institutions are subject to banking laws, and requires a regular audit and publication of a statement of condition. Other banks file a confidential statement and give advance notice of certain types of investment. The Swiss National Bank has no formal tools of monetary control and has traditionally relied on gentlemen's agreements, but scandals in the mid-and late 1970s forced it towards taking more formal powers.

The big Swiss joint stock banks are most nearly equivalent to Anglo-Saxon commercial banks. Some cantonal banks are chartered and supported by the cantons, and all have cantonal directors. They act as bankers to the cantons, but also provide most other banking services. Local joint stock banks are smaller commercial banks, without the branch networks and regionally concentrated. Finally there are the private banks, mainly partnerships or individual proprietorships.

Swiss banks are among the oldest international banks established in London and New York. Conservative and with massive customer deposits to invest, they have probably made a stronger impact on the bond markets than they have in bank lending, but are important in both.

Canadian banking has nationwide branching, with over 6,000 branches of its chartered banks, five of which are major banks on a world scale. They are subject to rechartering every ten years. Supervision is exercised by the Inspector General of Banks (Ministry of Finance) and the Bank of Canada, through detailed monthly reports and an annual inspection (mainly of head offices). Since the 1967 Bank Act relaxed the 6 per cent limit on deposit interest, competition has increased both among the banks and with other financial institutions. Since the mid-1970s, the law has been gradually changed to allow new entries, and in particular foreign banks on a carefully controlled basis.

Strong stock exchanges and institutional lenders elicit good financial disclosure, parallel in many ways to the US or UK. However, a major difference is that Canadian banks actively underwrite all types of debt issues, and are big holders. They are also permitted equity holdings but these are in practice relatively small.

Canadian banks have a history of international operations stretching back to the nineteenth century. Their offices in London are old established and strong, as are their New York agencies. They dominate much of Caribbean banking; the first Canadian branch dates from 1889, there were 118 by 1920 and nearly 200 today. Some Canadian banks are also strong in parts of Latin America.

Although the idea of the consortium bank is not new most consortia founded before the early 1960s either failed or established a standing in their own right. A consortium is established by a group of banks – usually either from several countries or from one foreign country – to provide an international or specialist service which the shareholders cannot offer individually. Initially this was primarily medium term lending, but some consortia also provide more general representation internationally or pursue specialities such as energy, or areas such as Latin America. Most consortia are based in London but there are many in Paris, Luxembourg, New York, Brussels and elsewhere. Many combine specialised commercial banking with investment banking, including the underwriting of Eurobonds. Often, after a few years' life, they find shareholders expanding into their speciality, and there is a continuing rearrangement of ownership.

Consortia banks had a difficult time during the 1973-4 crisis, aggravated by the secondary bank crisis in the United Kingdom. Although some ran into bad debt trouble and had to be rescued by their shareholders, the majority came through with some solid experience on which to build.

There are also the 'international clubs' such as the European Advisory Committee or Inter-Alpha group. These loose groupings – usually one bank from each of a number of major European countries – cooperate to provide a broader international service than they can offer individually. Sometimes this extends to establishing one or more consortia such as European American Bank. Often it is an informal arrangement to assist each other's customers on their respective home grounds and work closely with each other on major loans.

It is hoped that this brief survey will contribute to the understanding of the different backgrounds of international lenders, despite which worldwide cooperation takes place in many areas, of which the eurodollar market is the largest but by no means the only one. There is substantial international lending from domestic markets such as the US and there are developing markets in Asia and elsewhere, so that 'the eurodollar market' and 'eurodollar lending' are matters of fine definition. A series of relatively standard approaches and procedures to international lending is developing, and the inevitable disagreements as market practice grows and changes are less on national lines than on lines of enlightened self-interest and bank personality.

DEFINITION OF INTERNATIONAL LENDING

This introduction has mainly talked about international banks, but this book is about one aspect of banking – international lending, defined to exclude retail or personal lending. While the definition does not exclude interbank lending, this has special features which relate more to treasury management, and is discussed in another book in the series, *Money and Exchange Dealing in International Banking* by Nigel Hudson (see Bibliography). Otherwise, the phrase covers any form of finance, including acceptances, letters of credit, bid bond and performance guarantees, which meets at least one of the following criteria:

(a) it is in a currency foreign to either the lender or the borrower or both
(b) it finances international trade or cross-border investment
(c) it is made by a syndicate of banks of more than one nationality
(d) it is guaranteed by an entity outside the country in which it is made.

In practice of course many statistics are drawn on a different basis; there the definitions used by the statisticians will have to apply. Much of the comment will be specific to the eurodollar market or will have euromarket practices mainly in mind even though having perhaps more general application to wider markets.

2 Lending to Companies

ANALYTICAL APPROACHES

There are two analytical methods of lending to companies and evaluating their credit. It is possible to lend without analysis on security or on the strength of the name alone, but this is generally recognised as less sound and few banks admit to it. The analytical methods can be classified as the 'liquidation' (or 'gone concern') and the 'going concern'. The liquidation method looks at a company as it is now, compares its assets to its liabilities, making appropriate adjustments for a forced sale, and is satisfied if assets exceed liabilities by a sufficient margin. The going concern method looks to the balance sheet mainly to ensure that it can support the proposed level of operations. It looks primarily to those operations – on reasonable projections as to future levels – to generate cash to repay debt.

The liquidation method leads to secured lending to ensure that assets, when realised, are applied to repay the debt. In the UK a fixed and floating charge covers all assets; other countries allow a fixed charge on each individual asset or category of assets, such as receivables or stocks, but it is not always easy to take one charge on all assets.

Going concern bankers accept that companies whose assets fluctuate sharply (as with a toy company over Christmas) will repay borrowings from reduction of inventory and receivables in the normal course of business, rather than from operating profit or cash flow. They also recognise that security is appropriate for naturally self-liquidating transactions, such as commodity trade. They feel, however, that apart from these and a few special situations no banker expects repayment from liquidation of assets, but rather from cash flow and/or some type of refinancing. But (unless it is reluctantly provided by the same bank) refinancing requires cash flow to service it. Operating cash flow is thus the ultimate source of repayment for most bank loans.

Bankers need full financial information, historical and projected, to make the going concern method fully effective. Even the US and the UK require publication of historical information only, although a number of other countries are improving disclosure. Nevertheless, banks in many countries - including the UK - still rely heavily on security and on liquidation analysis in their domestic lending.

However, there are drawbacks to the liquidation approach, and to collateral, in international lending:

(a) Assets are often in several different countries, and realisable in different currencies. Both their availability and their value in the currency borrowed are problematical.
(b) Exchange control in some countries - and variations in company, bankruptcy and security law in all - make specialised knowledge of each country essential to obtain a valid pledge, or even to ensure that no other lender has a preferential position.
(c) The international bank, often not the main lender, may find the best assets already pledged.

Many of these problems can be alleviated by a well established branch, which is at no signifiant disadvantage to local banks. Small or newly established branches, however, run the risk of falling between two stools.

These features also complicate a going concern approach and must be fully allowed for in the analysis. The currencies of cash flow, for instance, can have a substantial impact on ability to service debt. However, by its nature cash flow is more mobile than assets. Many countries with restrictions on cross-border capital payments take a more relaxed view on payment for imports, royalties, management fees or even dividends, provided these relate to benefits gained or profits earned. Thus while it is essential to know the exceptions, a company with cash flow from several different countries is more likely to be able to use it to service debt than is one which merely has assets in the same countries.

All of these factors tend to push international bankers towards the going concern approach even if their domestic lending is not geared to it. Moreover, even in countries where disclosure is poor, larger companies with international aspirations provide more information and resist giving security. Their strength, however, enables them to control the disclosure of information and the loan agreement they will accept. With gradually increasing exceptions this is usually inadequate for a full going concern analysis and for sound medium term lending. Some features which push banks towards the going concern approach thus also limit its development. Even the strongest banks have to accept an element of name lending, however hard they work to keep this to a minimum. American banks – used to full information and frustrated by the lack of it – sometimes find their lending procedures almost counter-productive without the information to operate them.

Going concern analysis concentrates on cash generation to meet all obligations as they come due. But cash flow in this context is a future event. Analysis therefore tries to picture how the company will generate the cash flow it needs, which implies having an idea of how much it will need. To discover a company's future path the analyst must know the starting point and some history of how it was reached. Forecasts, to have any chance of being even approximately right, must be reconcilable with the past. Where an apparent inconsistency represents a genuine change in trend, the reason must be fully understood to assess the likelihood of the trend persisting, changing or reversing and the likely impact on the borrower.

THE TECHNIQUE OF GOING CONCERN ANALYSIS

The analytical starting point, therefore, is the balance sheet. However, analysis is not static and looks at the trend as much as the absolute level. Many individual items discussed below are also important in liquidation analysis; only the use made of them differs. The description will be familiar to American domestic bankers, but is not widely used in other domestic lending.

An analyst looks first at two broad indicators of strength or weakness, liquidity and gearing (leverage). Liquidity is a measure of the continuing ability of a company to meet its liabilities as they fall due. The first broad indicator is the current ratio. Other useful indicators are the quick ratio, the days' sales outstanding (or debtor turnover) and the stock turnover. The first two measure respectively the relationship of all current assets, and of the most current assets, to current liabilities. This gives a first pointer to whether current assets are turning into cash fast enough to meet current liabilities as they come due. The debtor turnover further indicates the average time a debtor takes to become cash, the stock turnover the delay before stock is sold and converted into debtors. These two items are for most companies the major current assets as well as the main raw material for cash flow, so that already balance sheet analysis begins to develop a connection with a going concern and to diverge from liquidation analysis. Finally, the relationship of cash, debtors and stocks to each other, in the context of the four ratios, gives a fair picture of the asset side of liquidity. On the other side, the nature (as well as the amount) of current liabilities is vital. And if debtors and stock are the raw material of cash flow, current liabilities are the fuel, burning and refining but leaving a much diminished residue.

Amounts and ratios tell the analyst little until he can estimate the quality of the underlying assets and liabilities. A slow turnover of debtors is a drag on liquidity (since debtors take longer to become cash, increasing the need for cash from other sources; conversely debtors are a potential source of cash, if turnover improves or sales decline). Secondly, it raises doubts about financial management. This is a question of relativities, since a manufacturer of heavy equipment normally expects to collect debtors more slowly than a retailer. When comparing like with like tentative conclusions can be drawn on the quality of debtors or management. Financial controls may be inadequate, concealing a broader weakness such as a high proportion of doubtful debtors, which may cause outright loss or prolonged preemption of management time. Or deliberately longer terms may reflect an uncompetitive product. Either way, if the raw material is suspect then forecasts and other assumptions are more so. (In liquidation, debtors normally realise the highest percentage of face value.)

In practice there are a number of possible explanations which cause no concern, such as a high proportion of export sales, which may take longer to collect, but are covered by export insurance. But even then the analyst in probing for the correct answer learns more about the company. Slow turnover of stock raises much the same questions about financial control, quality of the product and obsolescence. Obsolete or otherwise unsaleable stocks are just as alarming as uncollectable debts and just as important in liquidation analysis.

A going concern expects to pay trade creditors from collection of debtors, but anticipates that both will be self-renewing so that trade creditors are not a charge on cash flow or liquidity. If creditors are out of proportion and/or slow moving their eventual payment will preempt cash flow from other uses, or suppliers may refuse further credit, making them no longer self-renewing. The analyst therefore asks why a company has allowed its creditors to be so overdue. Poor controls, poor use, or lack of cash? Deliberate policy? But disgruntled suppliers can damage a company's business even when its immediate creditworthiness is not in doubt.

The relationship of debtors, stock and creditors and the extent to which the latter finance the two former can be crystallised in the concept of 'working investment'. Deducting creditors from debtors and stock leaves a residue to be financed. Changes can stem either from the level of sales, or from the turnover rate of one or more components. A rough indicator is:

Debtor turnover - days	90
Stock turnover - days	120
	210
Less: Creditor turnover - days	90
Day sales - working investment	120

The turnover of each item indicates the average period before the underlying transactions are completed, i.e. before stocks are delivered and invoiced or debtors or creditors paid. Thus with this debtor and stock turnover the customer has to wait 210 days between obtaining stocks and receiving cash from sale of finished goods. On the other hand, he in turn can wait 90 days before paying for the stock; he therefore has to finance himself only for the equivalent of 120 days' sales, not 210. A $1 million increase in annual sales, assuming no other change, would thus require an extra $333,000 of working investment.

The size and nature of unused bank facilities is important. Use of short term facilities in fluctuating amounts can be merely a means of taking attractive trade discounts or insulating suppliers from fluctuations in cash. Either way, these facilities are largely repaid from collection of debtors and are a small claim on cash flow, and a form of reserve liquidity. But the larger and more continuous the borrowing, the more likely that it is really for medium term purposes, requiring an allocation of cash flow to repay and suggesting inadequate liquidity.

Other frequent current liabilities include dividends, corporate income tax and VAT or other indirect taxes. For large figures, the precise due date is important since payment will require cash. Other less frequent items also need to be looked at for immediacy and flexibility of payment.

The individual components combine to give an overview of liquidity. An apparently strong current ratio, for instance, may be deceptive if assets are slow moving and the liabilities due immediately, and vice versa. More generally a company with slow-moving assets needs better liquidity.

No single ratio can give the whole answer, but there are a number apart from those already discussed, which can be useful as a sort of shorthand. An alternative to the quick ratio, also useful in liquidation analysis, is to calculate current liabilities minus cash and debtors as a percentage of stocks, since the more stocks needed to pay current liabilities the longer it takes a going concern and the greater the risk in liquidation. Another method calculates the days required to pay current liabilities given the turnover rates of debtors and stock. A third measure, which relates liquidity to gearing, is the ratio of current assets to total liabilities.

Liquidity is only one measure of balance sheet strength. Gearing measures the proportion of debt in total capitalisation, by comparing total assets to total liabilities, or net worth to either total liabilities or to borrowings. A distinction is usually made between tangible and total net worth, by excluding goodwill, capitalised research and development costs, etc. Since net worth does not have to be repaid, and has no mandatory servicing costs, it provides an essential cushion to service debt when earnings are low and to safeguard creditors against the almost inevitable fluctuations in earnings which might otherwise sink the company.

The quality and nature of the component assets and liabilities are important. Are the fixed assets old and in need of expensive replacement? Or specialised and not easily adaptable to other uses? Are investments appropriate and realistically valued? How are intangibles valued and amortised? Should they be written off immediately? Are debt maturities well spread or concentrated in excess of cash flow? How do borrowed currencies match assets or cash flow? What are other liabilities, how soon are they due, and in what concentration?

The acceptable level of liquidity and of gearing varies widely with the nature of the business, its assets and liabilities and its success. High liquidity can be combined with slightly weaker gearing or vice versa; a high capital intensity or a very long production cycle (which often go together) need more liquidity and lower gearing than a short cycle and low capital intensity; a highly competitive industry needs a strong balance sheet; and minnows competing with whales need all the balance sheet strength they can get. Most importantly weak liquidity and/or high gearing becomes more acceptable as sustainable cash flow and growth prospects improve. A strong balance sheet assists (and a weak one can hinder) strong operations and it allows weak operations to be improved or temporary fluctuations absorbed.

But a strong balance sheet cannot itself correct operating weaknesses while strong cash flow can transform a balance sheet.

Moreover, analysis of the balance sheet helps to pinpoint future requirements for funds. It thus assists comparison of sources and uses of funds, in which analysis of operations pinpoints the supply. Every asset (other than cash) and every liability is at different stages both a user and a provider of cash. Assets have to be paid for, but can later either be sold, or used to produce something for sale, realising cash. Liabilities represent deferment of payment and a source of cash, but subsequent payment uses cash. The relationship of assets to liabilities on the balance sheet and changes over time in their relationship to the operating statement have a substantial impact on the cash available and needed. In particular the analysis of fixed assets indicates their ability to generate cash or absorb it in replacing them, which in turn says something about their likely value in liquidation.

Operations provide the most important subject of a full going concern analysis, which should cover the last three to five years in as much detail as possible. It should consider changes in sales, in profits at various levels and in each major type of cost to assess the predictability, stability and sustainability of profit and cash flow. Profitability relates back to the balance sheet by ratios. These include return on equity or capital employed; net income (before interest and taxes) to interest payable, or interest coverage; and cash flow as a percentage of total or some specific liabilities.

This last is a good example of balance sheet and operations interacting to decide whether cash flow will be adequate. The relationship of cash flow to total liabilities is only a starting point. The importance of self-renewing liabilities, not normally a drain on cash flow, varies too much to permit reliance on this one ratio. Even cash flow as a percentage of total borrowing does not distinguish between payment dates, so the key ratio may relate cash flow to borrowings due within specified periods. However, this again relates cash flow to one type of use only. Capital expenditure may preempt all or part of cash flow. The increase in working investment for given increases in sales (whether real or reflecting inflation) depends on the turnover rates; whether this extra requirement can be financed from cash flow depends on the profitability of the new sales and the requirement for cash flow to meet debt incurred, or pay for assets required, to generate the sales. If cash flow is inadequate, the cost of extra borrowing reduces interest cover and cash flow both absolutely and in relation to liabilites. Weakness in these areas spreads to others.

The analysis should cover the breakdown of operations, by product and by geographical market or end user. A spread of products and markets can be a stabilising influence, although too great a spread can dilute management skills. A geographical spread gives protection against adverse economic conditions in any one country, although it involves exposure to complex currency and other risks.

But while the historical picture is essential to cash flow analysis, it is only a foundation. To build on it the analyst must look forward and judge whether cash flow will increase or decrease and how fast; foresee future claims on cash flow, judge their urgency and flexibility if supply proves inadequate; and assess the likely overall economic climate and specific market conditions which will affect generation of cash flow and any supplemental financing. Ideally the banker needs forecasts from the company. In practice it is the exception to give them (outside the US) although it is becoming more frequent; the analyst therefore has to make the best forward estimate he can. Where the market is well documented it is possible to develop fairly detailed forecasts. In most cases, however, the information permits only a fairly general picture, or an extrapolation from the past. The picture of requirements for working capital, fixed asset expenditure, etc. is equally general. Fortunately, a credit analyst unlike a security analyst does not require precision, but is concerned to see cash generation sufficiently above expected requirements to ensure that the company can meet unexpected fluctuations without crippling damage. Given this margin any likely excess is secondary, although still important.

Bankers used to the going concern approach fail to understand the reluctance of many European companies to provide forecasts, because of fear of adverse reaction if they prove wrong. These fears underestimate bankers who know the limitations and the factors that can upset forecasts. A forecast is a target against which to judge progress, not a commitment or guarantee. It shows whether the company knows where it is trying to go and why, and whether it can monitor progress effectively. No banker expects forecasts to be met absolutely; in fact, he will be suspicious if they are. No banker is unduly concerned at quite large deviations from forecast provided the company can explain what happened and can show that remedial action is being taken. (Of course, if the remedies do not work he will become concerned, but so should management.)

GOING CONCERN AND THE MEDIUM TERM

The going concern approach recognises that much bank lending is used for medium term purposes. Moreover many factors that affect a company's ability to repay even short term debt are themselves medium term, so that continuing evaluation of the borrower is essential. To accept a medium term commitment the bank needs financial covenants to pinpoint any major change in the company's affairs which may indicate a deterioration which should concern the bank. For both reasons the going concern bank requires prompt and up-to-date information, usually in the form of management figures quarterly, monthly or semi-annually. For smaller companies items such as a breakdown of debtors or of stocks should also be monitored.

DIFFERENCES IN APPLICATION

The basic principles of going concern analysis can be applied to almost any company; intelligent use of even minimal information can produce surprisingly good assessments. An international bank will find that the amount and presentation of information varies widely, as do the accounting and financial management practices. Reserve accounting, different treatment of reserves for tax purposes and preparation of accounts solely for tax purposes are much quoted examples. Less quoted are the differences in average creditor, debtor and inventory turnovers. Little attention has been paid to the way this expands both sides of the balance sheet, and the impact on comparative gearing ratios, which may explain why most American bankers think UK companies are more highly geared than US companies whereas most British statistics show the opposite. (The working investment concept might help to make comparison of different countries' balance sheets more meaningful.) Another example, at least as important in liquidation analysis, is the wide variation of attitudes to fixed asset valuation. And as countries begin to tackle the problems of accounting for inflation, this may become the greatest divider of all. While numerous specific examples can be given, perhaps the most important difference, and the hardest to understand, is in the purpose for which accounts are prepared and therefore what they are intended to show.

A bank needs volume to justify the cost of training analysts to handle the various different accounting requirements and to make the most of the information available. However, the going concern approach does not rely solely on financial statements, historical or forecast. A good analysis will cover, implicitly or explicitly, competitiveness, pricing, unions and labour relations, and will use information drawn from published sources, discussion with suppliers and industry information developed internally. The decision will also take account of the overall relationship with the company and of the quality of management. Opinion as to this will be affected by the figures, but will relate them to the other factors and to the control and knowledge of affairs demonstrated to the banker.

In brief, therefore, going concern analysis can be used in many countries although the detailed application will differ. However, it will be effective only if the bank has full understanding of the accounting procedures, the tax and company legislation, and the banking and general financial practices. This has important implications for the way banks must be organised to handle international lending. They must be prepared to adapt their techniques to local information standards and to use non-statistical information. For instance, the UK clearing banks carefully scrutinise the turnover in a company's account. This is a useful technique available only to the bank with the main account. Foreign banks who mostly do not have the main account should be aware that they are missing a useful tool.

CROSS-BORDER SUPPORT

One question more frequent in international than in domestic lending is the extent to which banks should rely on parent support, and in what form.

One approach is first to assess the credit of the subsidiary and lend on that basis alone. Alternatively if not satisfied, or as a matter of general policy, the bank can insist on some form of parent support. In that case, it views the parent in much the same way as when lending direct. Or it can refuse to lend except with a bank guarantee, transferring the problem to the guarantor. Or it may ignore the parent, but insist on watertight security. (It may, of course, do that in the first instance, if security is the normal basis for lending in its particular market.)

In the first and last approaches, the bank is concerned with the parent only to ensure that it does not undermine the subsidiary. A weak parent may siphon out (or upstream) more than the subsidiary can afford, through transfer pricing, royalties, dividends or otherwise. A medium term loan agreement can guard directly against some such risks, and indirectly against the balance, but when lending short term with no formal agreement extreme care is needed in the (fortunately unusual) situation. Even a strong parent may upstream profits into low tax zones, or to reduce exchange exposure, but then the subsidiary is less likely to fail as a result. Finally, where a subsidiary depends on the parent for supplies, technical support or research, parental weakness may undermine the subsidiary's viability.

Lending secured by a fixed charge the bank may be less concerned about the parent, although liquidation is always a time consuming business, best avoided if possible. With a floating charge or one over specific assets such as debtors or stocks, there is still scope for upstreaming.

A strong parent to which the bank looks for support is more common. If a guarantee is available, legal advice is necessary to ensure that it is enforceable. Lawyers are little help when a guarantee is not available, but some less formal support is offered. This may be called – depending on the bank and borrower – a keepwell, a letter of assurance or of comfort, or a letter of knowledge and concern, and no doubt there are many other names. Even an oral assurance may be accepted.

The best arrangement is a detailed letter with undertakings to maintain ownership and to keep the subsidiary solvent, or to ensure that it maintains a stated minimum working capital or net worth. This letter may impose more sweeping (if less well defined) obligations than an outright guarantee and is probably often legally enforceable; the wording and precise setting must be considered in each case. At the other extreme is a comment from a senior official that the bank 'would never lose money' or, more generally, that no bank has ever lost money by lending to subsidiaries. In between are undertakings to maintain ownership, general indications of knowledge and approval of the borrowing, expectations that subsidiaries will meet their obligations or claims to manage them in a way to enable them to do so.

These arrangements are not as valuable as a full guarantee; while morally binding, their nature precludes clear cut precedents and any insolvency official would certainly attempt to reject most of them. Exchange control - and in the United States the fear of stockholder suits - make banks reluctant to take keepwells. It is also sometimes difficult to be sure that bank and parent read the letter the same way. Expropriation is rarely mentioned in the letter; does the parent consider itself obligated if this occurs?

The subsidiary cannot be ignored, even where the bank looks to the parent. If it is a large part of the group, or manufactures an integral part of the product line, the parent probably cannot afford to let it fail; if it does, however, the parent may be dragged down too. Conversely, if the subsidiary is purely a small sales or start up operation, the cost of supporting it is minimal but the need for support is greater. A well established subsidiary going through a bad patch, or wishing to expand rapidly without the appropriate injection of equity, offers some real substance and a probability (though not high enough to justify unsupported lending) that it will be able to generate cash to repay or refinance the loan. This and the near certainty that in liquidation there will be some payout may make a keepwell more acceptable.

The payout in liquidation is sometimes overlooked, and will be discussed in Chapter 7. The borrower is always the primary obligor and presumably the parent believes that in time it can repay borrowing. Thus, however uncreditworthy the borrower, neither party expects that the bank will formally call on the support. Certainly if the bank thinks there is any chance that the parent would wait for such a call, only a guarantee or a very strong keepwell indeed is acceptable.

Some countries have legally binding support arrangements, such as the German Kreditauftrag. There are various types of partnership, for instance in Germany, France, Norway and Denmark. Where these place unlimited liability on all or some of the partners, any written support may be unnecessary, but it is essential to be clear on the exact legal position. One danger is that a relatively strong company can be undermined by small interests in weak partnerships which are not clearly identified in its annual report.

The country of the borrowing subsidiary and of the parent both influence the decision. Lending in a politically unstable or economically weak country requires more support, particularly if the currency is liable to devaluation or political and economic doubts reinforce each other. However, if the loan is from a local branch in local currency, exchange control risk is reduced and the devaluation risk eliminated.

If the parent is in a weak country, the risk changes again. The strength of both countries as well as both companies affects the final decision.

Exchange control, tax and other regulatory requirements are relevant. Exchange control may require official approval for guarantees of overseas subsidiaries. Some countries require substantial repatriation of earnings; such mandatory upstreaming may make support essential. Some countries require inward guarantees to be registered, or scrutinise capitalisation before approving. The American tax authorities increasingly look on guarantees as a substitute for capital and impute dividend income; many US companies have asked to have guarantees released to avoid this assessment. A keepwell may avoid some of these requirements but the bank must judge the particular situation, since a request for release may be a prelude to disposing of a subsidiary or letting it collapse.

In addition to all the above factors, the proper allocation of country risk must be made to ensure that the loan does not breach any internal controls, and overall exposure to the group must be kept within prudential or legal limits.

FITTING THE FACILITY TO THE BORROWER'S NEEDS

Going concern analysis considers what type of facility is appropriate. The banker thus needs to know the purpose of his own lending, the mix of borrowings and management's view as to how to achieve the best future mix. With international borrowers, it is also necessary to look at the mix of currencies borrowed; any mismatch with assets and cash flow must be manageable. The bank then negotiates an appropriate combination of facilities, available in the particular markets and currencies and meeting exchange control, local regulation, exchange risk and other requirements.

Every market has its own combination of facilities and institutions, so that certain facilities are provided by banks in some markets and by other institutions or government elsewhere. Some facilities, however, are fairly widespread; a summary of those common in international lending and in the eurocurrency market follows.

The overdraft is common to many countries. Theoretically payable on demand it is normally used to accomodate fluctuations in cash flow, preferably of a self-liquidating or nearly self-liquidating nature. While a variety of companies have requirements specifically suitable for overdraft financing, very few have a perfectly even cash flow; even if fluctuations are relatively minor, they justify at least some overdraft.

The overdraft is the simplest and most flexible facility with virtually no administrative burden. In addition the borrower pays only for the precise amount of credit used. For the bank the overdraft is a natural user of current account deposits (and may from time to time produce them) and thus particularly attractive to banks with a substantial base of current depostis (usually the domestic commercial banks). It is unfortunately sometimes used in cases where medium term lending is required. This so called 'evergreen' overdraft becomes very difficult to call.

The other main type of short term lending, substantially used domestically although it is also the main instrument in the eurocurrency market, is the line for short term advances. In the US this is the main form of short term lending, with interest traditionally linked to the prime rate but now more often to money market rates. In most other markets it is a secondary form, with the ability to fix interest for periods between thirty days and one year. It is commonly available in markets with an active interbank sector where the pricing can be linked to the appropriate interbank cost. The facility is used for broadly the same purposes as the overdraft and (in markets which offer both) many companies use the overdraft when lower rates are expected and advances when they are cheaper and/or rates seem likely to rise.

The other traditional short term types of financing, acceptances and bill discounting, are closely linked to each other and, traditionally, to the finance of trade. They are still widely used for this purpose, often on a bank-to-bank basis, but are also often used as a convenient method of finance in their own right. They represent - in theory although now not always in practice - the classic self-liquidating finance, with a link to a known receipt of funds.

Both acceptances and bill discounting can arise under letter of credit facilities, or independently; letters of credit are the classic (and still essential) vehicle of international trade and bank-to-bank finance. Their main features arise from the need to interpose a bank (or banks) between buyer and seller. This reassures the latter as to the source of his payment and perhaps allows the buyer time to dispose of the goods before providing cash. In its simplest form, the importer's bank opens a letter of credit (L/C) in favour of the exporter; this lays down what documents the exporter must present and what these must say about such aspects as volume, quality, insurance, date and method of shipment. Provided the documents are in order, and presented in time, the bank is legally obligated to pay the accompanying bill of exchange (sight L/C) or accept it payable after a specified period (time L/C). The exporter thus does not have to worry about the credit standing of his buyer, only that of the issuing bank.

In practice, he can often eliminate even this risk. The issuing bank will normally ask a correspondent in the exporter's country - often the exporter's own bank - to advise the L/C, but the exporter may ask for it to be confirmed. Under an advised L/C, the correspondent simply informs the exporter of the terms of the credit, and acts as the issuing bank's agent in checking documents. In practice, it will often also pay against the issuing bank's undertaking, but the exporter has no certainty of this. A confirming bank, for an additional fee, undertakes to pay or accept the bill if the terms are met. It thus takes over the risk of loss if the issuing bank is insolvent, or is prevented by exchange control or other regulations from paying promptly.

A time L/C creates a bill with life usually between thirty and 180 days. The exporter has the choice of holding the bill, or discounting it to raise cash immediately; he may be able to do so at a more favourable rate than he could borrow on his own credit, and/or borrow more than he otherwise could.

The exporter may choose to present the documents with a bill of exchange directly to the importer, who accepts the bill and returns it. If the importer is a strong credit, the exporter may again discount it at a favourable rate, without the importer bearing the cost of the L/C, which he might be unwilling to do. Alternatively, the exporter may present to his own bank appropriate documents relating to export shipments; the bank accepts the bill for a fee, collects the amount due under the documents and applies it to meet the maturing bill. The bank may discount the bill, or return it to the exporter to arrange its discount elsewhere. Unless the bill is drawn without recourse, however, the exporter remains liable to refund the bank if the importer does not pay; and, of course, a bank issuing L/Cs will arrange for its customer to reimburse it. (See also Chapter 4, Commodity Finance, for other types of L/C and trade finance.)

A sight L/C is thus an instrument for shifting credit risk. A time bill of exchange, whether under a L/C or not, adds an element of deferred payment, and/or allows cheaper financing because two or more parties are liable (hence the phrase 'two-name paper'). Because a bill is a negotiable instrument, there is usually a ready market for it, at a price which reflects current interest rates and the standing of the various obligors; each holder when he negotiates it adds his own endorsement and is liable to subsequent purchasers should the acceptor fail.

There are two essential points about all documentary bill finance. One is that the bank works only with documents. Provided they show what they should, the bank is not required – indeed, unless it has reason to suspect fraud, is not permitted – to look at the validity of the actual transaction. And it follows that once a bill has been accepted and negotiated, it stands on its own, even if fraud is subsequently proved, and the acceptor and any endorsers are 'liable on the instrument'. While individual laws on negotiability may vary, the essence does not. Moreover, the International Chamber of Commerce has established a code for letters of credit which is accepted worldwide.

These features of negotiable two-name paper have caused bill finance to be used for other purposes than financing international trade. A bill may be drawn even where there is no underlying transaction (a finance bill) or it may be used to finance domestic trade.

Acceptances are often used by central banks to provide liquidity to the banking system. They may have to meet standards of eligibility relating to the transaction (as in the US) or to the accepting bank as in some European countries, or both as in the UK. Bills tied to specific transactions are often also used to provide subsidised finance for purposes or borrowers which governments wish to encourage. The importance of bill discounting varies; while little used domestically in the UK or the US, in a number of European countries it rivals the overdraft as the main means of finance and is of course a major feature of trade financing.

Short term borrowing is one part of bank finance which in turn is one part of the total financing picture. A sound mix between short, medium and long term borrowing and equity requires a knowledge of the facilities available in each market, the conditions under which they can best be used and the availability of longer term debt and equity from other institutions.

The three main medium term facilities in the eurocurrency market are also available in domestic markets with well-developed interbank sectors and no regulatory restrictions. However the depth of the market, particularly in fixed rate lending, depends on local conditions and the preferences of both lenders and borrowers.

The revolving commitment is similar to the short term advance facility, but is contractually committed, subject to certain conditions, for periods of two to seven years, occasionally longer. Repayment of all or a portion does not cancel the commitment, which gives greater flexibility in tailoring borrowings to cash flow. It can be used as a standby or insurance policy against future uncertainties; for longer term fluctuations in cash flow; or where the original need is fairly certain and generation of cash flow assured in amount but uncertain as to timing. Increasingly it is used as a back up for forms of borrowing in the securitised markets.

With a fixed term, fluctuating rate loan the full amount is borrowed immediately or within a short period. Once borrowed, repayment cancels the facility to the extent repaid. This is appropriate for known requirements, such as a capital programme. Or it may fund excessive short term borrowing to restore balance to the capital structure.

On a fixed rate, fixed term loan the rate is set at the time of borrowing for the whole life of the loan. Its use is broadly the same as the fixed term, floating rate loan, but it is particularly appropriate for a company with high gearing and high vulnerability to interest costs. It may be most attractive where there are rapid variations in interest rates; a borrower can fix a rate for a three to five-year period to see him safely through subsequent interest fluctuations.

These three facilities link interest to the interbank market for the appropriate period and currency. In the first two, the customer usually has some flexibility in choosing the period. All can also be combined in various ways – for instance, a revolving commitment can convert into either type of fixed term loan after, say, two years. The conversion date often relates to the beginning of amortisation. Another frequent combination is a floating rate loan with an option to fix for the remaining life on any rollover date. Companies can avoid being locked into high rates, while retaining the ability to fix if and when they decline.

Finally all the facilities linked to the interbank market can be offered in a multi-currency form which, while denominated in a specific currency, allows borrowings in other currencies subject to availability. These may be eurocurrencies only, or domestic currencies through various branches, or both. Availability in local markets depends on credit conditions and exchange controls.

The performance bond or guarantee became more important than previously in the mid-1970s. It comes in two parts – the bid bond and the true performance bond. The first is usually small, perhaps 1–2 per cent of the tender, and is released for all except the winner; its purpose is to ensure against frivolous bids, and it is forfeited if the contract is refused by the winning bidder.

The performance bond is usually 10–15 per cent of the contract price, which can mean a liability of hundreds of millions of dollars. The bond covers failure by the contractor to complete on time (or at all), or of the plant to run properly for a given period after completion. Smaller performance bonds have been given without undue worry within overall credit limits for years. Some of the very large contracts which came out of the Middle East and a few other oil producers after the oil shocks caused concern for three main reasons.

First, the bonds normally call for the bank to make payment on written demand from the buyer, without regard to whether the contractor actually has failed to perform. In most countries a bank which pays has a valid claim against the contractor, even though the demand may have been unwarranted; this has been confirmed in court cases in the UK and US. However, some countries (France for one) might not uphold a bank which paid on demand without checking that the demand was valid, whatever the wording of the bond. The contractor must then try to recover his money from the purchaser, often the government of the country concerned. Banks are reluctant to issue bonds in favour of countries which are considered liable to act arbitrarily.

The second problem is the difficulty of analysis. On large contracts, the guarantee may be substantially larger than any bank would lend. On the other hand, the bank does not actually expect the contractor to have to repay, as in a loan. Analysis may be directed, therefore, more to judging the contractor's ability to complete the contract. A clear view may be possible in cases where the contractor has a sound track record, but where there are untried elements, subcontractors not known to the bank or a host of other factors the risk increases rapidly, but often unquantifiably. (This makes the first risk even less acceptable.)

The final problem is sheer size. A bank which might be prepared to innovate with a trusted customer for $1 million or so, is going to think twice before doing so for $50–100 million; and no one bank can handle a $200–300 million deal on its own, which therefore means syndication.

The various types of facility outlined in the section Use of Securities in New Forms of Lending in Chapter 1 must now be added to the traditional list above, either as new facilities or as ways of making existing facilities more flexible.

ELEMENTS OF PRICING

The pricing of any facility can be broken down into three factors, the underlying cost of funds to the bank, the minimum (or prime) margin above cost and a premium for lesser quality borrowers. From these three the bank must cover operating expenses, provide for loss and liquidity reserves and obtain a return on capital. The premium for quality can be anything between $^1/_{16}$ per cent and 3 per cent. In addition, there is a medium term factor, recognising the greater credit risk and funding risk in unpredictable market conditions.

The extent to which these various elements can be identified varies. In the US, for instance, the prime rate includes the first two elements in pricing and any addition is a premium for other factors. Most other domestic markets have a wider variety of facilities with different rate patterns, so that there is no easily identifiable or single prime rate; even the United States has introduced a variety of such facilities during the 1980s, so that prime lending rate is much less important. In interbank markets the offered side of the interbank rate represents the cost. The margin to be added depends on the period and on local ease or tightness of money, competitiveness and views on current and future operating costs.

Although interest is always important in pricing (and is often the only factor), other forms can be significant. They include compensating balances in the US, and commitment, management or facility fees everywhere. Some domestic markets charge fees for the availability of even uncommitted facilities. A commitment fee on the unused portion of any committed facility is, from the borrower's viewpoint, an insurance premium; it used to be charged at a standard ½ per cent, but competitive pressures have pushed it down to ¼ per cent or less. At levels below ¼ per cent, a small but growing number of banks refuse to commit. Management fees are charged for syndicated facilities, part of which may be paid to larger participants, and occasionally for providing a substantial non-syndicated facility in lieu of the syndication fee. Finally there are agency and operating fees for continuing management of mechanical operations in a complex loan.

Acceptance facilities and bill discount facilities are normally priced at the rate at which the bill could be discounted in the appropriate market, plus a commission. Because an acceptance is the prime obligation of the bank, whereas on a discounted bill the bank is only a contingent obligor, there is a differential.

The question of who gets prime rate - however that may be defined in a particular case - is less clear cut. It will vary with market conditions; in tight money banks will be reluctant to grant it, while when money is easy they may relax their definition. A category of 'super prime' also appears, at least on very short term borrowings, when money is particularly easy. Banks will adjust their criteria differently to fit the patterns of their business. It is easier to vary the rate when the prime element is not too clearly identified; thus interbank rates can be more flexibly treated if the borrower knows only his all in cost; in the US (or in the UK on overdrafts) the borrower knows the exact relationship of his borrowing to prime and is more likely to resist an adverse move, or appreciate a favourable one. The existence and pattern of official reserve or liquidity requirements and how readily they can be varied also affects overall levels.

Apart from market conditions and the creditworthiness of the company the overall relationship normally affects margins. This is more formal in the US where banks normally require current account balances as part of the compensation or some form of fee in lieu. US banks also keep fairly precise figures on the overall profitability of an account. In the rest of the world, profitability is monitored rather less formally. A bank lending in one country may have to adjust its pricing to recognise profitable business in another country. A bank will not grant a company less than prime rate where that is clearly defined, however good the relationship. But for companies which are on the margin between any two levels above prime, or where prime is not well defined, the relationship - both actual and prospective - is very important. It carries most weight in times of easy money; in tight money it will earn greater availability rather than lower cost. It can include current account balances, profitable discount, collection, letter of credit or other activity, or foreign exchange business. Time deposits at market rates also count but are given less value; although banks like to have varied sources of money, it does not directly add to profits.

The pricing of securitised types of lending (FRNs, NIFs and so on) at first followed a similar pattern, with FRNs at a margin over LIBOR and the underwritten cost of NIFs including a similar margin on usage and a commitment or underwriting fee. Competition has meant that these prices are now expressed in basis points (1/100 of 1 per cent = 1 basis point), rather than ½, ¼ or even ⅛ per cent. Indeed in the auction of notes under the various structures the best names measure success by the number of basis points below rather than above LIBOR they attain. This in turn has put great pressure on margins (and commitment fees) on the more conventional types of facility.

3 Country Lending and Country Limits

BASIC PRINCIPLES

The basic principles of country and company analysis have some similarity. Country analysis covers the economy and its management, its resources and cash flow, assets and liabilities, ability to refinance by borrowing, by grants or aid from other countries or international institutions. However, the size and complexity of a country, the political and international implications, the variety of borrowers in each country and of natural resources and external political and economic factors all make the analysis more complex.

There are three major differences between a country and a company. First, the government can print money, so that lending to a government in its own currency should be risk free. In practice, the possibility of refusal to pay remains, and is slightly greater where the lender is a foreign bank. The second difference is that a country cannot go bankrupt, so that there is no legal mechanism for forcibly realising on its assets; conversely, it does not cease to exist and defaulting countries have occasionally repaid, part or all of, their loans decades after a default. Nevertheless, this all or nothing aspect of lending to governments affects the view of acceptable risk. Thirdly, country risk encompasses not just governments but a wide variety of borrowers affected by conditions in a country, although for many country risk is only a small part of total risk.

Techniques for analysis of countries are less advanced than those of companies. While most bankers would accept the description of company analysis in the previous chapter, with differences in emphasis, there is still no generally accepted method of analysing countries. Some writers regard the balance of payments as the key starting point, others external debt, others economic financial management.

A full analysis of a country requires an economic staff as well as bankers closely familiar with the country. Both need to be accepted as people worth seeing by local bankers, the central bank and Treasury/Finance Ministry. Not every bank can afford this, and only a few banks analyse a wide range of countries in depth. Even these will not analyse a country at a cost disproportionate to earnings generated from it

THE ANALYSIS

One possible starting point is the political climate and management of the country. Sound political institutions, a mechanism for an orderly transfer of power, acceptance of the obligations of previous governments are all desirable, as is competent political management and a viable alternative government. The quality of economic bureaucracy and its influence on political management are very significant. So is the reaction to major changes in external factors, such as the oil shocks, inflation and recession of the 1970s and early 1980s.

Apart from competence and stability, bankers need to judge the political climate and political will. Do social and political conditions allow effective action to combat inflation, to improve the balance of payments or to redirect resources into exports or investment? Or will the reaction of the electorate - and, particularly in more advanced countries, of the unions - cause political, social or economic unrest, and undermine the benefits of sound actions? This is a question both of political climate and of political will. The question may be not 'can the government?' but 'will the government?' Politicians worried about re-election may very well put off effective action even when observers believe it would improve their electoral chances. Although largely subjective, judgment of political climate and will is vital in assessing a country's creditworthiness.

An alternative starting point - the external financial position - involves a detailed assessment of the performance and outlook of the balance of payments. The breadth and diversity of exports, their relative price trends, reputation for delivery and reliability and the extent to which other countries compete for key markets will be considered for a developed industrial country. For a lesser developed country, the degree of reliance on one or two products, especially when they are volatile in price or demand, is important. Conversely, dependence on imports, particularly for energy and raw materials, and vulnerability to price increases must be considered as well as potential import substitution. External debt - both absolutely and in relation to trends in exports and imports - is also crucial, as are its growth, terms, maturity structure and interest cost. These are compared to capacity to service debt from balance of payments, refinancing and aid prospects from international organisations or developed countries. The resulting indication of the extent to which requirements are covered is related to the level of official reserves. These should be adequate to finance normal trade payments and to provide some cushion for unexpected fluctuations in exports, imports and/or prices. Borrowing rights at the IMF (although not normally included in reserves) provide a genuine source of liquidity, comparable to a company's unused bank debt. Where appropriate, unused commitments from the World Bank and other international institutions as well as commercial banks may also be considered.

The use of the debt is important; investments which generate exports or save imports create a source of debt service not available from consumption, prestige projects or, worst of all, corruption.

A sensible assessment of balance of payments and external finance must be based on an understanding of the interaction of the domestic and external economies.

The analysis of the internal economy breaks down into several sections. The natural resources and potential for development are particularly important for an underdeveloped country as are the human resources, the degree of training and skills, the quality of education and the ability of people to learn. Other key factors are the ability of management and entrepreneurs, the volume of savings, the adequacy of the tax structure for government expenditure and its balance between incentive and redistribution.

If the country has mineral reserves, their location, cost of production and the size of the investment needed, all affect the analysis. If primarily agricultural, is it efficient, well diversified and self sufficient in many aspects or narrowly concentrated on one or two inefficiently produced products, with volatile markets and high imports?

In a lesser developed country aspirations to industrialisation must be measured against the available infrastructure (transport, power, sewage etc.) or the need to divert scarce resources to install it. Is the approach to industrialisation sensible, or based on prestigious white elephants? In a developed country, diversification or concentration are assessed, particularly concentration in declining industries where the country is losing competitive position internationally. Is industrial/economic policy designed to reinforce strength and eliminate weak industries as painlessly as possible? Or to support the weak at the cost of diverting resources and stunting the growth of the stronger sectors?

Apart from the general question of human resources, the quality of unions and labour relations, attitudes to work and pay, willingness to change location and job, all affect productivity, as does the propensity to invest. Steady investment, well managed, helps a country to maintain its competitive position, while a history of low investment, poorly managed, suggests that the effort necessary to regain competitiveness may put unacceptable strain on the balance of payments and the social structure.

Whatever the priorities, all aspects are important. Ample resources may make life easier but will not guarantee good management nor will lack of resources preclude it. Two neighbouring countries, Zaire and Zambia, are both heavily dependent on copper, and were both hard hit by the oil shocks and high interest rate and by unrest in neighbouring countries throughout the 1970s. For many years, however, Zambia's performance on bank debt was far superior to Zaire's. Ironically, just as Zaire began to make real - and at least partially successful - attempts to improve its performance, Zambia's performance deteriorated drastically. There are also many people who feel the UK government has used the benefits of North Sea Oil to cover up poor management of the economy rather than strengthen it.

It is important to be sure that the economic policies and long term strategies are in line with the country's resources, economic and social structure and people's preferences; policies which conflict with reality introduce damaging distortions into an economy. However, the situation at a given time is the result of a variety of natural and historical forces which cannot be reversed overnight. Policies and strategies compatible with the basic factors and working to improve them are probably as much as can be expected.

The relative importance given to various factors will vary according to the country being analysed as well as the bank analysing them. For a western democracy, it may be fairly easy to assume orderly political change and acceptance of the obligations of preceding governments, although as the UK and Italy have shown the political will may still be lacking for prolonged periods. The importance of external political factors is low for most European countries, except insofar as they affect international trade. On the other hand, the 1974 oil price increases and the Angolan fighting had a major impact on the ability of Zaire and Zambia to export copper and badly upset their economies. The threat of Vietnamese aggression in Indo-China reduced the perceived creditworthiness of countries in the area.

Political and management analysis cannot be presented statistically and many banks are sceptical of the value of ratios in the analysis of countries.

However, some ratios have become generally accepted, although the Latin American problems starting in 1982 suggested that their predictive value is not very great, and set off a search for ratios which are sensitive to change. The two most common of the traditional ratios are coverage of imports by reserves and the proportion of exports needed to service debt. A minimum coverage of three months' imports by reserves and maximum annual debt service of 20 per cent of exports are considered the limits for safety. Some bankers rely more heavily on ratios and A. McWolfe, Jr (in *Off Shore Lending by US Commercial Banks*, see Bibliography) gives quite a long list of ratios and a procedure for ranking them. Alternatively some banks have a point system and others use matrices. In an article in *Euromoney* (December 1977, p. 67) Richard Puz described the matrix used by Bank of America to analyse countries and at least some other banks use a similar system. Even those that remain sceptical of such mechanical aids may agree that an intelligent use of ratios has value as a shorthand for main areas of interest.

The events of 1982–3 showed that banks need ratios which take into account the structure of debt – and, in particular, the possibility that short term debt will not be rolled over; only these will predict problems far enough ahead to permit banks to take defensive action in time. T. H. Donaldson in *How to Handle Problem Loans* (see Bibliography) discusses some developments in predictive ratios; their main aim is to relate export earnings to debt structure in various ways which allow for the impact of adverse change.

The adequacy of information in lending to countries is a matter of comment and concern, but the comment sometimes overstates the problem (and may by doing so help to reduce it). Sources of information are improving and countries are becoming more aware of the importance to their credit standing of reliable, current statistics. The speed, coverage and reliability of economic statistics varies considerably; the major developed countries publish wide ranging information reasonably promptly, with full seasonal adjustment, while some of the Less Developed Countries (LDCs) publish little and late, leaving bankers in some doubt as to whether they have the information themselves.

Apart from sources specific to each country, the World Bank and the IMF publish various statistical series on their members. The most useful and consistent of these are the World Bank's tables of world debt (updated monthly) and borrowing in international capital markets; and the IMF's International Financial Statistics.

The latter relies (at least for domestic information) on statistics produced by each country, and the detail varies. Although published monthly it is not always fully up to date, but provides in one source summary information covering an extended period on items such as Gross Domestic Product (GDP) and GNP, gross capital formation, government consumption, main items of government finance, monetary movements, domestic and external debt, balance of trade and payments, and price movements in major export and import items.

The Bank for International Settlements (BIS) collates fairly detailed information as to the borrowing by various countries from the banking system. The Federal Reserve system and the Bank of England provide details of borrowings from all banks under their control. This is based on information gathered from banks and therefore independent of the borrower. All three sources continually aim to improve their reliability and coverage, and these figures provide a valuable picture of the structure of country debt, and also of the extent to which it is offset by deposits with the international banking system. This in some cases transforms the overall picture.

In addition, there are many secondary sources of information for banks whose size or volume of business in a particular country does not justify a full sifting of primary sources. These often also constitute useful background information even for a full analysis. Such sources include detailed economic reports published or provided for a fee by major banks, some of which also provide monthly statistical sheets or news letters; staff papers on a variety of subjects by the IMF and other organisations; a wide variety of comments on individual countries, ranging from magazine and bank reviews, more detailed economic and political studies, down to topical newspaper comment and an occasional shrewd article from a knowledgeable journalist. With a good understanding of this background information, individual news items mean much more. Finally, a close study of commodity markets gives a fair idea of developments affecting countries heavily dependent on them. Naturally, all of this information should be supplemented by continual visits to the country, for banks which do not have a branch on the spot.

Country offices at the IMF and the World Bank are usually willing to discuss informally their views of a country and its development. Central banks and foreign offices of major countries are also often well informed and willing to advise on the latest conditions and concerns, at least to their own banks.

For all this, it remains true that even the statistics of developed countries vary in quality and are presented in different ways. Despite their often much simpler economies, LDC statistics (particularly on domestic economies) are too often sparse and unreliable. Banks negotiating with Zaire, for instance, had to spend several months investigating Zaire's debts and ability to service them before they could begin to formulate proposals. Moreover, even where prompt and reliable statistics are produced there is no uniformity in their coverage or meaning. This is one reason why some banks discount the value of statistical analysis and of the more mechanistic rating systems. On the other hand, the ability to provide prompt and reliable statistics is, as with a company, one aspect of management and the borrower who comes in with comprehensive information clearly presented makes a strong impression.

Undoubtedly, further improvement in country statistics and their collation and dissemination by international agencies is vital to the ability of banks to continue lending to countries. Any press or other comment which helps drive this home to borrowers and makes banks more inclined to insist on it as a condition of lending is thoroughly desirable. (Even some Communist borrowers, who are notoriously secretive, are beginning to recognise that to borrow large amounts on fine terms requires better information.) However, it is going too far to suggest, as commentators sometimes seem to, that all lending to LDCs is unsound because of lack of statistical information. Other sources and forms of information are often adequate to justify substantial exposure. Good lending is not making perfect decisions on perfect information, but judging on the best information available whether a loan is sound. Knowledge of exploitable resources may be a better assurance of eventual repayment than the most detailed statistics.

Despite some similarities the risks of lending to countries and companies also reflect some different factors. For instance, the inability to bankrupt a country means that legal remedies are unlikely to be very effective, so that banks are more dependent on goodwill for repayment. Moreover, if a country repudiates its debts, the bank is likely to lose the whole loan, whereas the ability to distribute a company's assets makes at least partial recovery likely. Adding to this is the sheer volume of loans covered by country risk. It is not certain that if Ruritania defaults, all Ruritanian companies will also default, but it is at least a possibility and some inevitably would. So that the danger of misjudging a major country is likely to be far greater than misjudging a single company. Against this, the fact that a country does not disappear leaves the possibility, however remote, that a future government will pay all or part of the defaulted debt, if only to re-establish its credit. This has actually happened in the past and the permanent need for credit is seen by many bankers as one of the most important assurances of continuing payment.

Another difference is diversification. Companies can spread their operations over a number of different countries. This does not eliminate the risk of expropriation, but a properly structured loan has a real chance of recovery from overseas assets. A British company with 50 per cent of its assets and profits outside the UK is thus not a pure UK risk. Although it will be affected by vagaries of the UK economy and currency, overseas operations and substantial exports give significant protection from events in the UK. A loan to Her Majesty's Government (HMG) cannot have the same protection and this is not fully allowed for when the company is classified as UK risk. This is even more true where the borrower is an overseas subsidiary with some substance of its own, classified as UK country risk only because of a guarantee.

This leads to the question of whether a company can be a better credit than its country of origin. In domestic currency the answer must be 'no', since governments alone can print money. The answer is more obscure for foreign currencies, particularly when there is a clear claim on overseas assets. It is well known, for instance, that before the 1976 IMF agreement the market view of UK credit was very low. There was considerable doubt as to HMG's ability to raise syndicated bank loans, and no doubt it would have to pay a higher interest margin than other major countries. These doubts spilled over onto UK companies in the eurobond market, but good companies even of the second rank continued to borrow from banks at fine rates. Similarly ICI was rated AAA by Standard and Poors when the UK was close to its lowest ebb; this was justified largely by ICI's 50 per cent or more non-UK sales, and it is doubtful whether HMG would have been rated AAA at that time. Thus while such judgements are ultimately subjective, markets clearly sometimes consider individual companies as stronger credits than some countries.

The decision as to whether a given exposure is acceptable depends on the mix of credits included. The extent to which the exposure is to, or guaranteed by, government or banks, rather than corporate; the proportion in local or foreign currency; the extent to which corporate borrowers are purely domestic, are multi-national or have overseas parentage; the proportion of short term, trade related, medium term or even long term credit in the total figure, are all vital. Some banks break the limit down only between maturities, others between bank or government and corporate lending, others both, but all affect the degree of risk. If there is a large volume of medium term lending to government, particularly of an LDC, a distinction used to be (and sometimes still is) made between the 'balance of payments' and 'project loans', although the events of the early to mid-1980s strengthened the views of those who doubted its value. Broadly speaking, a balance of payments loan is available for the overall funding of an external deficit or as a reserve of liquidity. The lender relies on the country to make good use of the loan, but has no direct control over (or even knowledge of) the actual use.

Project loans (defined more broadly here than in Chapter 4) at least in theory provide money for a specific use; sometimes payments are made solely against progress certificates or similar documentation. The bank satisfies itself that its loan is used to generate specific products for export, to replace imports or benefit the economy in some other identifiable fashion. (In the case of export projects it may even be possible to have receipts paid directly to the lending banks.) As well as generating cash for repayment of debt, this specific benefit should make it harder for any new government to repudiate the loan, particularly if the project needs further finance at the time or in the future. A balance of payments loan has no such specific benefit and can more easily be repudiated on the grounds that it was used to build up personal accounts in Swiss banks or resulted from improper pressure to buy luxury or prestige goods the country did not need.

Experience has shown that once debt is being rescheduled, the distinctions between different types of loan disappear; however, as a means of ensuring sound use of the money lent, project lending may still have some advantages. Project loans are most common in LDCs, both because much of the world's mineral resources are found in them and because the projects are often either owned (or the finance guaranteed) by the government. Also many LDCs lack the economic structure to justify borrowing unless it is tied to specific projects which are at least potentially self-liquidating.

The control of the use of funds is another area of major difference between country and corporate lending. Although major companies may resist the imposition of covenants, the banks at least have a set of tools with which to ensure that their money is properly used. The threat of default provides a lever on financial management to recognise the importance of key ratios and seriously attempt to keep within them. Major projects, diversifications, etc. are less likely to be undertaken if they would threaten these ratios (and through them the repayment of loans) even where they are not specifically prevented.

There is a general feeling on both sides, however, that it is not appropriate for private lenders to impose economic policies (which meaningful covenants on a sovereign government would do) and that the sanctions for breach of covenant in any case are not very credible. Ultimately, except for assets not protected by sovereign immunity, the ability of a bank to collect depends on the integrity/goodwill of the borrower. If a government does not wish to repay a loan a bank cannot make it, although its ability to raise new loans will be seriously restricted. Also, it is difficult to find ratios which, as a manageable group, are a sufficiently reliable guide to a country's economy and its ability to repay its debt. This reliability is essential to justify calling a default.

These weaknesses have led to a growing involvement by the IMF and World Bank, sometimes in conjunction with private banks; often this involvement is a condition of banks supporting a suspect country. It is felt that international organisations are better placed to enforce meaningful conditions and also to obtain full and continuing information without causing loss of sovereignty, and without risk of damaging commercial repercussions to themselves. While banks generally welcome the IMF's actions, some are concerned in case the IMF becomes a substitute for independent judgement.

Having analysed the country and looked in general terms at the nature of his exposure, the banker now has to set an actual limit. He first has to decide what loans should be included. Obvious decisions cover loans to the government and its various agencies or the central bank, borrowings under government guarantee, or by nationalised industries or local government units. Then it gets more complicated. If, as suggested above, some companies' credit standing is improved by substantial overseas operations, is it correct to include loans to them in the home country limit? If so, is it also correct to include loans to strong overseas subsidiaries, whether guaranteed by the parent or merely supported by some form of keepwell? The theoretical permutations of country risk are numerous, since in lending to an overseas subsidiary of a strong parent a bank is looking at elements of at least two and sometimes more country risks. The question of how much of each is complex and variable, but logically the country risk should be split (not necessary equally) between the countries.

In fact, no banks appear to split the risk. The only published allocation of risk is made by American banks to meet the requirements of the Securities and Exchange Commission (SEC) and/or banking authorities. These reports have a legal implication which may not coincide with commercial realities and can lead to allocating country risk to the guarantor, even where the direct borrower is stronger; or treating loans secured by cash or marketable securities as the risk of the country in which the security is physically held; or allocating a loan secured by a ship to a country it never visits, such as Panama or Liberia (or even landlocked Switzerland if the Greek owner who guarantees the loan happens to have his main residence there). Lawyers do not take kindly to the idea of assigning all ships to Oceania.

Banks setting their country limits solely for commercial reasons seem to fall into three main categories. Some put the risk in the borrower's country regardless of support; some put it in the country of the guarantor; and finally some, while they incline to one approach or the other, follow a fair amount of judgement to be exercised at that margin. A few smaller banks put the whole risk in both countries. Any of these are reasonably practical, provided some mental adjustments are made. For a bank with a significant branch network country risk is already sufficiently complex to require a computer to follow it. To allocate parts of a loan to different countries on subjective judgments, or on varying types of support, complicates it more than the benefits are worth.

In setting a country limit the bank has thus to consider all the factors discussed above which affect the credit, and the factors which relate to the risk which the bank is actually undertaking. Two banks with an identical maximum limit to a particular country may be accepting very different risks depending on how the exposure is made up. In looking at specific cases, there are several aspects of country risk which have different impacts on various types of borrower. They can be classified under four headings and some subheadings. These are not in any way definitive but merely a covenient form of shorthand. For this purpose, then, the four main headings may be considered as:

1. Political Risk.
2. Political/Economic Risk.
3. Economic/Commercial Risk.
4. Sovereign Risk.

Political Risk

This can be looked at under two subheadings: lending on government credit and corporate lending.

In the case of government lending political risk covers conscious refusal to pay, for whatever reason. It may involve a new government repudiating external debts 'improperly' incurred or 'not in the national interest'. Alternatively, an existing government may repudiate some or all of its debts. This is harder to justify psychologically and even more damaging to the country's credit standing, but can happen.

The earlier discussion of political stability and the likelihood of an orderly change in government is relevant to this risk. Even where an unconstitutional change is possible, however, the probable attitude of the new government to international loans may be affected by the responsibility of the old government and the nature and purpose of its borrowings. Lending to an irresponsible government for frivolous purposes or overpersuading it to borrow more than it can productively use are dangerous for this as well as more obvious reasons. The insistence on lending to finance specific projects attempts to protect against this risk.

For companies the political risk is more diffuse. It may take the form of expropriation (although in many cases nationalisation, even on terms which may be considered expropriation, improves the credit; the obligation becomes that of the government) or of punitive government action making a company unable to pay. A particular risk is of restriction on the company's ability to purchase foreign currency. (This is more likely to arise for political/economic reasons but can occur in either case.)

Assessment should cover the possibility that political factors may actually improve prospects for repayment. Thus in countries such as Sweden, the United Kingdom, Italy and Japan, companies which would otherwise have caused banks substantial losses have been either taken over outright, subsidised or guaranteed. This, it is claimed, avoids damage to the domestic economy and employment, to defence capability or to the international credit standing of the country. There can thus be an element of political judgement in lending to a company. The problem is to judge which companies are covered, and whether the government can achieve its objectives by allowing a company to go into liquidation and taking over all or part of its assets at a knock-down price. This maintains the jobs or the defence capacity but does not protect the creditors. Too much protection may involve a dangerous distortion in the government's finances, the economic management of the country, or both. In the long run this may do more to undermine a country's credit, and the strength of the corporate sector, than even the most spectacular crash of a single company. Before North Sea Oil and Mrs. Thatcher, the UK appeared to be heading in this direction; Italy and Sweden are only two of the countries which have, at one time or another, faced a similar threat.

Thus while recognising the existence of this political support, many bankers prefer to ignore it in their analysis and decision as to whether to lend. The concept of Japan Inc., Sweden Inc., or Great Britain Ltd is fuzzy. The question of which companies are part of it (if it exists) is fuzzier still.

Political Economic Risk

The differentiation of political/economic from pure political risk is not clear cut, since economic factors may cause political upheaval. However, the concept covers economic risks arising as a result of political failure or mismanagement or external political factors out of government's control. The risk is thus of a government willing and trying hard to pay its debts, but simply not able to do so. Although the immediate factors are probably financial or economic, there is a background of political failure – whether of will, integrity or competence – which while it does not necessarily create the economic and financial circumstances, allows them to get out of control.

Judgement as to the seriousness of political/economic risk and the danger of it degenerating into straight political risk is a difficult one. If banks are satisfied that the government is making constructive efforts to repay its loans and re-establish its international credit they have a real interest in helping by granting extra time (and even credit) while problems are solved. For business and public relations reasons, as well as humanitarian ones, they are usually reluctant to be the cause of excessive economic stringency which may lead to hardship, social or political unrest and revolutionary change of government with all that implies. On the other hand, if banks are too relaxed other creditors may be paid first leaving insufficient resources to meet bank debt without even more severe measures and an even greater risk of political upheaval. Banks are conscious, too, of the danger of setting a precedent. If they are too tough borrowers may decide that the cost of trying to satisfy them, in terms of domestic political upheaval or hardship, is just too great. If they are too generous, other borrowers may conclude that they do not need to be good creditors to borrow, an equally dangerous precedent.

The nature of political/economic risk means that careful handling carries a high probability of eventual payment but often only after an extended and worrying period. Because countries often borrow from many banks it can be at least as difficult to get the banks to agree on the right balance as to get the country to accept a reasonable solution. Finally, banks have to remember that the political leaders of some countries may well be putting not only their peoples' welfare but their own lives at stake in their efforts to repay the debt.

The impact of political/economic risk on companies is complex and takes various forms. One form, sometimes called currency risk, is inability to use domestic currency to buy foreign currency due to the central bank's regulations. Another aspect of currency risk is devaluation, increasing the local currency equivalent of the amount originally borrowed and reducing net worth and earnings; in extreme cases even a company with profits above forecast may be pulled under by this risk. If the company is prevented from buying foreign currency during a prolonged period of devaluation this compounds the problem very seriously.

Political/economic risk also covers the prospect that economic management as a whole, or as it relates to particular industries, may make it harder for companies to remain solvent. This can encompass general factors-demand, incomes and monetary policy and particularly price controls-or more specific factors such as restricted credit to certain sectors, subsidised competition, expensive environmental or other controls and so on. The impact of these items on individual companies will of course be considered in the analysis of each company. However, the whole portfolio in each country must also be considered, to assess the extent to which lending is concentrated in sectors vulnerable to such risks.

Economic Commercial Risk

Economic/commercial risk really only applies to lending to companies. Even a politically stable country can have a weak economy for reasons which do not reflect on current political management; they include lack of natural resources, weak industrial base or too few skilled personnel. In these circumstances the economic risk is often very high in certain industries, and is higher in almost all than in a strong economy. This may, however, have some interesting implications in assessing the overall quality of industrial management. The high reputation of German and Japanese management reflects to a considerable extent (although it may also contribute to the strength of their economies. Many of their managements have simply never had to cope with the economic problems that their British counterparts, whose reputation is generally much lower, take for granted and it is not clear how well they would handle them. When markets or individual banks rate German or Japanese companies higher than British companies – because of nationality rather than on a detailed comparison – they are reflecting a judgement on economic/commercial risk. However, such a judgement may be too simple. A strong economy can have institutions and structures which increase economic/commercial risk. The very high gearing of Japanese companies, and their great difficulty in reducing labour, makes many of them much more vulnerable to economic cycles than British companies, unless they are part of a close knit group or zaibatsu. Combine this with high capital intensity, a heavy dependence on export markets and a world recession and a strong yen can put far more companies at risk than similar conditions in the UK. This type of point must be considered in analysing the risk involved in a given exposure to Japan, which may be more readily acceptable if the bulk of it is to banks, or to major companies which can count on support, rather than to smaller companies.

Sovereign Risk

This concept attempts to take account of some of the cross currents of country risk described above and to describe the possible loss to a bank arising from upheaval in a country, whether or not that country is the one to which the risk is allocated for calculations of country risk. It broadens the concept of country risk and cuts the precise link with the bank's balance sheet by putting the same exposure in more than one country. For instance, deposits with a foreign branch of a US bank are normally US risk since the bank is one legal entity. However, expropriation of branch assets and liabilities might invalidate this assumption. Similarly, an expropriated parent might be ordered to siphon all the cash out of its unguaranteed subsidiaries, or the new government might lay claim to balances or other assets of the borrower in a third country. The success of such a claim, and of any counterclaim or attempt to set off, would depend on the legal framework and perhaps the political climate in the other countries. Similarly, failure or expropriation of a strong subsidiary might undermine the parent's credit and the value of its support in a third country. Thus although country risk is allocated to one specific country, sovereign risk covers any country which can have a major effect on the prospect of repayment of credit. The concept can be illustrated by suggesting that, for instance, a loan from the French branch of a US bank to the Italian subsidiary of a British company carries four sovereign risks but only one country risk. This is impossible to cover statistically, but there are four governments and four sets of laws involved. The US, in particular, is often accused of trying to obtain extra-territorial jurisdiction for its laws, so perhaps the example is not so far fetched.

In this form, sovereign risk represents a worst case analysis. It can be softened by taking into consideration the other side of the balance sheet and assuming a right of set off on deposits or other liabilities in the defaulting country, so that a new figure is reached. While subject to many qualifications this figure does throw some further light on the risk involved in lending to a given country.

Sovereign risk is a less precise concept than country risk, and can never be more than a general guide. This may even be an advantage because spurious precision can give a wrong impression as to the true risks involved in lending across the borders.

4 Specialised Forms of Lending

This chapter deals with three important specialised forms of lending, predominantly international in nature.

PROJECT LENDING

This phrase describes loans where the main or only source of repayment is the project being financed, in which banks consider two separate types of risk - pre completion and post completion. The post completion risk is analagous to the risk of lending to a one product company, except that there is no historical record and market analysis is more speculative since production will not start for several years. Before that point, however, the bank has to consider the risk that the project will never be completed.

Apart from specialised cases such as leasing or shipping companies, only a limited range of borrowers are involved at all frequently in project finance. They include governments, borrowing directly or through agencies or national companies, for most types of project; utilities or quasi-utilities (often also government-owned), to finance capital intensive projects with an assured payback; oil or mining companies or partnerships, to finance extractive projects, and sometimes the related infrastructure; joint ventures, to finance major industrial plants without either partner having to take the whole risk; and occasionally major industrial companies who for various reasons are interested in off-balance sheet finance.

Pre Completion Risks

There are four main types of risk which can prevent completion of a project. Their relative importance and ease of analysis vary but all must be satisfactorily covered before the project can find finance.

The Technical Risk

Is the technology involved well proven? If a major part is untried, are there alternative solutions available if it fails? Is it being applied in favourable conditions or (as in the early days of the North Sea) may previous experience be a poor guide? The bank will normally have to rely on outside consultants for feasibility and other studies on these points but will still need to evaluate them and assess the risk in the light of all the factors.

The Contractor's Risk
Again the bank will rely partly on outside assessment of the contractor's competence, but should also be able to check his record and experience in similar projects. In complex projects, similar questions may need to be asked about a number of major subcontractors.

The Timing Risk
Prolonged delays can add to costs through inflation and additional interest. This can substantially change the expected coverage of costs by cash flow, or can add further degree of uncertainty to the analysis of market factors, in the post completion period.

The Financial Risk
How is the project funded, how much equity does it need, can any cost overruns be financed and how likely are they? The financial strength of the owner/operator will be carefully assessed in the light of these questions. The most conservative view would require the owner/operator to be able to pay off the whole loan from cash flow unconnected with the project. In practice, banks often accept something less than this. The financial strength of the contractor - while less important than when fixed price contracts were common - must also be considered.

Until the early 1980s banks hardly took any significant pre completion risk themselves. The pressure of competition has weakened this stance somewhat, but pre completion is still recognised as an area of high risk, which banks must control tightly. The development of satisfactory credit support in this sphere involves knitting together a package of technical studies, performance bonds on contractors and completion/refundment guarantees from banks or strong owner/operators of proven expertise. The bulk of the risk not taken by the banks must be borne by one or more strong corporate credits but their commitment may be to complete the project rather than a direct obligation to repay the loan. The size of most projects and the impact of a major failure, therefore, usually precludes simple reliance on a balance sheet without assessment of these other factors.

Post Completion Risks

Post completion risks can also be divided into four types, although again their importance varies.

Raw Material Risk
Where the project is an extractive one, technical studies establish that the mineral exists in sufficient quantity to cover the costs. In a sense this is a part of the technical pre completion risk. But for manufacturing or processing plants, the assured availability of good quality raw materials is essential.

A Continuing Operating Risk
Once complete, can the project be relied on to run at sufficient volume and cost to generate the needed cash flow? Is it vulnerable to fluctuations in raw material or energy costs, wage inflation, high interest rates or plain bad management? For extractive products, how easily can the mineral be recovered?

Commercial Risk
This is divided into volume and price. Will there be sufficient demand to keep the project operating above breakeven and will the price be sufficient to cover costs?

Political and Force Majeure Risk
Political upheaval (as with the Shaba invasion in Zaire or strikes in various countries) can force the operator to declare 'force majeure' and cease delivery. Force majeure can arise for other reasons, some technical, some natural (flood, earthquake, fire or storm). Political risk also includes retroactive enforcement of pollution controls, conservation rules, penal taxation or even outright expropriation, as well as changes in licensing rules.

In the purest project finance the bank will take all these risks or at least protect itself against them without reliance on a corporate credit. Or the bank may require complete corporate support, making it a project loan in name only. In between, the bank may take some risks but not others.

There are various forms of protection. In a take or pay contract, natural users commit to pay for output from the project at prices which will cover all costs and debt service even if there is no output, giving protection equivalent to a full guarantee. (Variation's such as throughput agreements for pipelines or tolling agreements for processing plants differ in detail but not in principle). Or the obligation to take can be limited to actual production; or to non-availability for specific reasons only; there can be a fixed price, usually with cost escalation, rather than a guarantee to cover all costs; or even a market price related to an agreed indicator such as the price on the London Metal Exchange.

A few examples of other methods include continuing operating guarantees (for a period long enough to solve teething problems, or permanently); the arrangement of fixed or minimum price contracts with outside purchasers; cash deficiency agreements (which may also be used for pre completion risks) to cover any shortfall in cash flow; specific government approvals or exemptions from regulations or taxes which could interfere with repayment of the loans; and many other devices specific to particular projects.

Project finance can be used to finance ships (see below) or assets such as computers for leasing where the rental income is the source of repayment, and pre completion risk very minor. The concept more commonly covers mining, including oil, and construction of major items such as nuclear power plants, chemical or oil refineries, steel or other heavy processing plants. Bridges, roads, pipelines or ports can be separate projects or part of larger projects.

In financing installation of platforms and/or pipelines in the North Sea, for instance, the bank must be satisfied with the owners, operator and subcontractors which may be a problem where the owning partnerships include weak members. Looking ahead to completion, the bank must be qualified to assess the reports of outside consultants on the oil and extraction risk and whether these reports assure it of an adequate safety margin in the light of the economic or other risks it may be considering. Many operators are natural users and take the economic risk, by a fixed price contract (acceptable in view of relatively low operating costs) or limited take or pay; or the bank may require a continuing operating guarantee for a variety of reasons. The bank must also look at government regulations on all aspects of North Sea Oil–from ownership, through tax to production and conservation rules.

The emphasis of risk in a metal mining project may be different. For instance, the price of copper is volatile but the extraction risk is often quite easily assessed. The bank may find the production and operating risk acceptable but need cover on the market risk. It can require independent purchasers (who will certainly not pay for non-production) to sign firm contracts at a fixed or minimum price, with cost escalation. The purchasers are usually well diversified to avoid concentration of credit or political risk. Or the bank can take a view on demand for copper by the time the project starts to produce. Firm contracts are normally safer, but may be available only at prices which leave inadequate margins for cost overruns, or at best allow only a relatively slow repayment of the loan. If some assurance of earning power is considered essential, a base load of fixed price contracts may be required, leaving additional capacity available for sale at market prices, and a strong recapture clause if prices are high.

Amortisation of most project loans will be flexible. It must meet conservative expectations of cash flow but also provide for delay or reduction in particular circumstances; this was important in early North Sea loans where the extreme conditions made delays likely. Most project loans also have a tight recapture clause, so that the benefits of early production or favourable demand and price are used to reduce the loan.

Borrowers choose project finance for tax advantages; the isolation of major borrowings from the balance sheet; the unwillingness of strong shareholders to support weak ones; and the inability of all but the largest companies to finance such enormous costs on their own. Sometimes they also see bank involvement as an important protection against the various types of political and regulatory risk to which all projects are subject.

Project lending thus requires an unusual combination of skills; specialised knowledge of each type of project and the laws relating to it; specific techniques of lending; judgement of commercial prospects and finally assessement of the stability or otherwise of the host country.

The basic criteria of project financing set out above remain valid. However, intense competition has here, as in other areas, increased the type of risks banks take. Many banks now employ petroleum, mining and other types of engineer in specialist project finance departments. Whether the extra skill outweighs the extra risks to leave sound credit standards is a moot point; the answer probably varies from bank to bank.

SHIP FINANCE

Apart from being an important form of lending in its own right, ship finance provides a useful illustration of the ways in which pure project finance can be modified and diluted until it becomes a corporate credit.

Some forms of ship finance are possibly the purest project lending of all. In favourable conditions a strong operator almost simultaneously used to be able to obtain a long term charter for a ship, arrange for a competent yard to build it at a fixed price, and for a major bank to guarantee a refund of interim payments if it was not delivered on time. To finance this he arranged a bank loan for 70–80 per cent of the cost, granting a mortgage on the ship and a formal assignment of charter hire. He might provide the remaining 20–30 per cent himself or obtain it from the shipyard against a second mortgage.

The bank bases its loan on the security of the first mortgage but more importantly on the assignment of charter hire. Since the charter is, in this example, the prime source of repayment the bank examines the charterer almost as it would an unsecured borrower. Of course, the mortgage usually has some value above scrap but a charterer is most likely to fail when profitable charters are hard to come by and therefore capital values are well down, perhaps only a fraction of cost. A bank which takes the charterer for granted may find itself looking to the owner for a shortfall, although if its assignment was properly drawn and the bankruptcy law of the charterer permits, it probably has a claim for damages against the charterer's liquidator. The charter hire must cover operating expenses plus inflation and service the debt, even on pessimistic assumptions about interest rates. If all or part of the finance is in a different currency to the charter hire, the exchange risk must be considered. The borrower's financial stablility, operating competence and costs must be assessed. It is no comfort having a strong charterer if the borrower operates the ship so poorly that the charter is broken, or if costs run out of control, so that the charter hire does not meet them and he has no other resources.

A standard charter provides no loophole if market conditions turn against the charterer, or if the owner becomes insolvent, provided steps are taken to continue operating the ship. Deviations from standard need careful review. (A bareboat charter under which the charterer takes full responsibility for the vessel is safer, but is likely to have less profit potential for the owner and is relatively infrequent.)

The legal aspects of ship mortgages are very specialised and Admiralty lawyers must be familiar with the legal systems in countries such as Liberia (based on English law), Panama and Greece, where many ships are registered. A banker specialising in shipping should, as with any type of lending, become familiar with the broad requirements, but documentation of mortgages, more than in most loans, requires precise knowledge and must be drafted separately; the Admiralty lawyer's mortgage is incorporated in an agreement prepared by a commercial lawyer. The banker must understand the business implications of the various legal points, the different types of charter, the position if either operator or charterer breaks the contract. He also needs full knowledge of the different types of insurance, since an inadequately insured ship is poor collateral, and most ships carry at least three types. The bank must look at the quality of the insurer, since while Lloyds and most experienced marine insurers will pay promptly once the loss is agreed, there have been cases of slow payment, due either to illiquidity or dubious ethics. Borrowers who choose to insure at low rates run a greater risk of this happening than most banks are willing to accept. Sound systems are also necessary to monitor renewal of the insurance and receipt of charter hire when due.

Not all ship finance is pure project lending, or even project lending at all. A bank may finance 60–80 per cent of the purchase price of a second-hand ship, repayable over five to seven years even though the charter has only three or four years to run. The bank may rely on its knowledge of the particular market and on the owner's ability either to obtain a new charter or sell the vessel to cover the balance of the loan or the owner may pledge other vessels, perhaps with an agreement to release them if an acceptable new charter is obtained; or he may have a profitable fleet, with a moderate level of debt and strong cash flow to support the loan. Loans against vessels operating in different markets or with different charter periods can be cross collateralised to spread the risk.

Loans are also made against unchartered vessels which may be in a profitable trade where long term charters are not appropriate (the liner trade is one example). Or the owner may have a diversified fleet with surplus cash flow and may wish to operate some vessels spot until time rates improve. The bank's decision may be affected by the expectation that, at the appropriate moment, the vessel will be profitably chartered, but this can be proved wrong and the bank should not rely on it. Finally, there are a few shipping companies whose financial condition is so strong that they can borrow unsecured.

In all cases the bank needs full knowledge of the operator's competence, the makeup of his fleet and cash flow (charter position and operating costs) and of his debt and debt service. It needs to know enough about the various trades to judge the operator's vulnerability to a decline in one or more markets and whether he has taken adequate defensive measures; above all it needs a constant review of the fleet's charter position to ensure that charters are replaced as they run off, or that the vessel can operate profitably without a charter.

This type of analysis is very different in detail to analysing a company, but the same basic principles apply and there is a similar difficulty in obtaining information. American, British and Scandinavian owners will mostly provide at least a minimum of information to their lenders. Greek owners, perhaps because of tax worries, are often obsessively secretive and the bank may have to rely on guesses as to the owner's personal worth, perhaps supported by glimpses of statements of deposit accounts or other evidences of assets, with no indication of liabilities. Although many loans made on this basis are safely repaid, it is not really a sound basis for lending. If the present slump in shipping continues and owners who have already negotiated or are trying to negotiate moratoria prove unable or unwilling to put their personal wealth into their business, the standing of the Greek community and its ability to borrow may suffer permanaent damage, even though a small number of the strongest owners will be unaffected.

Ship finance, even when secured by a full payout charter, is an above average risk for banks. The cash flow is narrowly based; even apparently good charterers fail, mostly at times when the ship is worth least. The risk is greater when the charter is insufficient to pay the loan in full. Even where the risk is spread over different types of vessel, with different economic cycles, the cyclical nature of the industry remains and there is enough connection between trades so that a major decline in one often spills over into others. This high risk poses two general dangers to bankers (both of which apply in other high risk specialised areas such as property). The high rate of interest required to justify the risk may attract inexperienced banks into the market at the top of the cycle, when they make unsound loans themselves and in so doing undermine the standards available to more experienced banks.

The other danger is that specialists, putting too high a premium on their own techniques, believe no one else can assess them, apply normal credit standards and controls. This inbred complacency is potentially more dangerous than ignorance, and in a sense the greater the expertise used to rebuff independent scrutiny, the greater the danger.

COMMODITY FINANCE

Commodity finance, inherently international, is in many aspects similar to other forms of trade finance, but there are some special features.

Commodity trading and dealing companies are highly specialised, with balance sheet and earnings profiles very different to manufacturing, retailing or service companies. Their assets consist mainly of cash, trade debtors and/or stocks, with fixed assets usually very small, and liabilities are confined to short term bank debt and/or trade creditors, taxes and dividends, with often a large contingent liability for bills discounted. Both debtors and stocks normally turn over very quickly; this and the self-liquidating nature of their transactions enables them to borrow up to five or six times their capital (occasionally more for short periods).

Because the trader/dealer adds nothing to the commodity, but provides only skill in buying, transporting and financing, the profit margin on each transaction is small. To earn a sound return on capital thus requires a high volume of transactions, which, in turn, requires borrowing.

The result is a company with very liquid assets but a very low current ratio (1.1 is typical, against 1.5–2.0 for manufacturing companies), and a tiny cash flow in relation to debt. This is one case where liquidation of assets in the normal course of business, not cash flow, is the expected source of debt service. As long as business continues normally, new assets are constantly purchased with new debt, so that total assets and liabilities may be substantially unchanged; when business is slack, both sides of the balance sheet contract sharply, and later expand just as quickly. The balance sheets of many commodity companies – particularly those trading in large individual cargoes, or in a seasonal or cyclical commodity – gyrate in a way which would be most alarming in a manufacturing company. These factors make financial analysis of the kind described in Chapter 2 less valuable than for a manufacturing company, and explain why commodity finance is usually secured. Many specialist commodity bankers believe that financial analysis is a waste of time, and that what matters is their knowledge of the workings of the commodity market and the techniques of financing and security. While not wholly accepting this viewpoint, credit men can agree that the emphasis of the analysis has to be rather different. It remains true, however, that if a company is sound, it will pay its debts whether they are secured or unsecured. Factors making it unsound may well also undermine the value of the security and could, in at least some cases, be pinpointed by analysis.

A distinction is made for this brief discussion between a trader and a dealer. A trader buys commodities only where he has firm orders, so that he has no risk (provided neither buyer nor seller defaults) from changes in price of the commodity. He may act as principal or more often as agent; quite often, as del credere agent, he takes the credit risk of the buyer. His skill lies in matching buyers and sellers of specific commodities and arranging shipment and finance for a commission. Grains, timber and pulp, natural fibres and similar products are commonly handled by traders.

A dealer buys and sells, for his own account, both physical commodities and forward contracts on various commodity exchanges. He may be the true owner of stocks on board ship or in warehouse, or he may have a contract to deliver but no physical commodity. At different times he will probably have both, and will also perhaps have contracts to deliver and accept delivery of the same commodity at different times. Metals and foodstuffs such as cocoa, sugar, coffee and tea are some of the commodities handled by dealers.

Both traders and dealers, as individuals, usually specialise in one or a small number of commodities, but larger firms are active in a variety of markets. And while the distinction between functions is valid, many firms do both, and even those which are predominantly traders still sometimes take positions and dealers often deliver physical commodities to a manufacturing user. In other words both, as intermediaries, play an essential part in getting the commodity from the place where it is produced to the ultimate consumer.

In analysing a commodity company, it is important to know whether it acts mainly as trader or dealer. A trader may have large amounts of stocks and/or debtors on his books. But since the stocks are pre-sold their turnover is rapid, as long as the buyer is reliable. Since a dealer usually has no firm buyer, his stocks tend to be much higher than his debtors. Unless he is fully hedged (which cannot be checked from the balance sheet) he is exposed to variations in price which can cause enormous losses – or profits. The analysis looks for ways in which the borrower is vulnerable.

With a trader acting as principal or del credere agent, this means looking at the spread and quality of his customers to ensure that he will not be faced with crippling bad debts, and at the reliability of his suppliers, since failure to deliver, a late delivery or substandard quality may involve the trader in a claim from his buyer. This means looking at management controls as much as at individual names or transactions, since these can change so fast. However, analysis of changes in the turnover of debtors and inventory (although these can be distorted by the rapid fluctuations) can pinpoint factors threatening adverse change; for instance, the appearance of much larger than usual stocks, while it may have a natural explanation, may also suggest either that the company is changing its pattern of business, or that a buyer has failed, leaving it with a large open position. Similarly, profitability should be related to volume rather than price. A large increase in profit margins with little or no increase in volume may be a warning sign of dangerous speculation.

The argument that no analysis of a trader is necessary provided the security is sound thus falls down on two points. First, if the company's business controls are sloppy, this throws doubt on the value of the security. Banks deal with documents and rarely see the underlying goods, so that their main assurance that everything is in accordance with the documentation must come from the management of the borrower. Secondly, it is the company that borrows and is liable to repay, not the security. The expected source of repayment is of course the specific transaction covered by the security; the risk of it going wrong, while small, is greater than the bank would be justified in taking if there were no other source of repayment. The bank looks to the company's financial strength as a secondary source, which it must be satisfied is adequate.

A dealer, by definition, does not have firm buyers for his commodities before he buys. He may hedge all his physical purchases on the appropriate commodity exchange; or he may deal substantially in future contracts, taking his profits by buying or selling matching future contracts, as well as or instead of physicals. He may also act as a broker, buying and selling on the exchange on behalf of customers. If they fail to meet their obligations, he is still liable to the exchange. While few traders admit – to their bankers at least – to speculating, most agree that they take positions. Bankers are suspicious of the distinction but it seems to be based on knowledge and control. Speculation, in the pejorative sense, involves backing a hunch, trying to make a killing, and if it does not work out, playing double or quits with the bank's money. Taking positions involves research and understanding of the markets, specific objectives, tight controls on the size and nature of the position and, above all, the courage and controls to cut losses early, and take profits without being greedy.

This distinction cannot be easily assessed by balance sheet analysis, unless supplemented by close knowledge of a company's policy on position taking and of its controls. It will thus always be the quality of management which is crucial, but the balance sheet and profit and loss account can give pointers. Large stocks for a company which says it does not take positions need explaining; even more so does a large increase in either stocks or debtors, and an apparent slow down in their turnover, which may indicate unsuccessful positions or large potential bad debts. And the point about profits is as valid for dealers as traders. However, because of the volatility, annual review alone has little value; it should be supplemented by quarterly (or ideally monthly) figures and it may even be desirable to get key items of information weekly. This, in turn, requires internal systems to ensure that they are received and examined, even when the banker is absent, so that any hint of deterioration is acted on quickly.

There are numerous cases of commodity companies, traders and dealers, taking large losses on individual transactions or on dealings with a single group. Reasons have included fraud, unauthorised dealing, failure of a supplier or buyer of physical commodities, failure of other dealers to meet their contracts, or of brokerage customers to pay their debts. Many sound companies have survived such losses, and the bank financing the particular transaction which failed has not lost money. But where the company was unsound, or where its controls were inadequate to contain the loss to a manageable size, a number of banks have lost money. Financial analysis may not give complete protection, but it is a necessary part of it.

The techniques of financing commodity trade also vary between traders and dealers. Traders, because they mainly handle movement of goods, use letters of credit quite heavily. They quite often use back to back L/Cs, where the buyer's L/C in their favour is collateral for an L/C in identical terms (except that the amount excludes their commission) issued to the seller. Transferable L/Cs, the benefit of which can be transferred without the buyer knowing the name of the ultimate beneficiary, are also used. Where the buyer is a strong credit, or for other reasons unwilling to issue an L/C, the trader may finance by delivering the documents to the bank for collection and borrowing an agreed percentage; the bank, when the collection is complete, pays off the loan and remits the balance. Although this could be considered a specialised form of receivable financing, bills of lading are negotiable instruments, so that title passes to the bank on delivery for value, which greatly simplifies the transaction, since there is no registration requirement, or need for elaborate formalities. (However, air bills are not negotiable, and goods shipped by air are not usually good security.)

With a dealer, bills of lading or L/Cs are used if he ships commodities, but mostly he is likely to hold physical commodities in an independent warehouse, pending sale. These are usually financed by providing the bank with receipts (warehous warrants) certifying that the goods are held either to the order of a named party or to bearer. Many warehouse warrants are negotiable and effective documents of title, so that the goods may only be delivered against their presentation; they thus provide valid security. Moreover, the bank in this case can (and should) periodically check both the security and environmental controls of the warehouse and the physical existence and quality of the goods. However, not all warrants are either negotiable, or documents of title. In some cases they are transferable but not negotiable (in which case the bank cannot have a better title than the dealer and is subject to any liens, etc. incurred by the dealer). In others, they are merely an acknowledgement of the original delivery and impose no restriction on moving the commodity out of the warehouse, or any transfer of title or security interest.

Each country has different rules. In England, for instance, some warehouses were established by private Acts of Parliament, which specifically made their warrants negotiable; warrants of other warehouses are not negotiable. In Germany and Holland (whose warrants are frequently used as collateral outside those countries) warrants are divided into specific types, with graduated degrees of negotiability and protection of title. (The names and exact details differ between the two countries, but the basic concepts seem to be similar). It is important, therefore, to know which type of warrant you are taking and what its exact status is in its home country, as well as examining the precise wording of the particular warrant.

Even when the warrant is satisfactory it covers only a specific weight or volume of commodity, and gives no assurance as to value. Most banks require a margin of value (usually 10 per cent) above the amount of the loan. So small a margin can be justified only if the commodity has a large and established market with prices published daily, and if the bank's security interest and internal controls allow immediate sale, if necessary. Valuations will normally be checked at least weekly, and should be taken daily for commodities which are very volatile in price. If the collateral margin drops below 10 per cent, the bank should immediately request more collateral or a reduction in the loan; if this is not quickly provided, the bank both can and should realise its collateral, to do which it needs fully negotiable warehouse warrants. Because commodity prices are so volatile, and a commodity company can fail very quickly, it is essential to have procedures to identify a problem and move fast.

Dealers also require guarantees to the various commodity exchanges to cover margin requirements - i.e., if the dealer has an open position he is required to keep a percentage of that position in cash or a bank guarantee with the exchange. Since markets move so sharply, the amount guaranteed changes daily. The maximum guarantee, therefore, has to be set at a figure high enough to cover all likely eventualities; but if it is too high, it represents an unnecessary cost to the borrower, so the figure is likely to change quite often. The willingness of the bank to issue such a guarantee, and its collateral requirements, if any, depends on its understanding the conditions under which the guarantee is likely to be called.

Thus, as with other specialised types of finance, lending to commodity companies undoubtedly requires knowledge of the way the industry works and of the lending techniques. A banker skilled in lending to manufacturing industry cannot pick up that knowledge and technique in a few weeks. But here, too, the danger exists that skilled commodity lenders will think that the industry is so special that general principles of lending do not apply to them, and that controls and information requirements applied to the rest of the bank's business are irrelevant.

In addition to pure commodity companies there are, of course, many companies which use commodities and trade in them as part of much larger operations. Chocolate manufacturers with cocoa, cigarette manufacturers with tobacco, and certain metal fabricators or electrical equipment manufacturers with copper, are obvious examples. While they may use some of the specific financing techniques, analysis of their credit standing relates mainly to their wider business, although with some allowance for any extra vulnerability to fluctuations in the price of the key commodity.

5 Syndicated Lending and Modern Forms of Multibank Lending

SYNDICATED LENDING

Many projects are too large for one bank to finance alone, and most project finance is syndicated. Syndicates of between three and 150 banks also combine to lend amounts as small as 10 million dollars or as large as $3 billion for many other purposes.

Syndicates enable lenders to spread their risk, avoiding too much exposure to any individual borrower or project, lending to a wider spectrum of different borrowers than they could find alone. Less sophisticated lenders obtain indirect access to the credit judgement and marketing of more sophisticated banks, although the extent to which any bank should rely on another is a thorny problem, discussed later in the chapter.

A borrower can expect to raise larger amounts through a syndicate than through a series of individual loans or from one bank. He explains his financial condition and requirements once; negotiates one agreement, pays one legal fee; has an expert to market his loan and present his credit; puts his name into the market once only and so does not compromise his ability to borrow again.

The costs of syndicated loans are set on the same principles as other loans; the most important difference is that rates of interest are apt to become known. Even where they are not deliberately publicised, the market is usually aware of them and treats them as an indicator, particularly in times of changing trends. Thus, in favourable conditions, banks try to avoid conceding too much on a syndicated loan, particularly since, for most members of the syndicate, there is usually no close connection with the borrower and therefore no hope of other business. However, in competitive conditions such as those in the first half of the 1980s nothing stops erosion of margins.

Syndicated loans are also apt to incur more fees payable at the time of signature though single lenders of large amounts will claim fees where conditions permit. Managers always receive a fee for working out the terms of the facility, negotiating the loan agreement and marketing the loan; they also often commit to a major part (sometimes all) of the loan themselves if necessary. To market difficult loans, or any loans in difficult conditions, the managers may have to pass on some part of this fee to participants, either in proportion to the participation (say 5 basis points for $5 million, 7½ for $10 million and 10 for $20 million) or to any participant taking more than a specific figure. In really difficult conditions the managers may require the borrower to pay this fee rather than give up part of their own.

Whenever the facility is not used for any significant time, there will be a commitment fee. For many years this was a fairly standard ½ per cent. From the mid-1970s onwards, however, it came under steady downward pressure. By the mid-1980s only a few banks were even attempting to hold the line at ¼ per cent, and many banks were accepting less than ⅛. It seems likely that some banks now waive it altogether.

The differential for quality can in times of tight money be quite steep. However, because spreads are more likely to be generally known than fees, and because the composition of fees is much more variable, the differential between spreads is more likely to be compressed in times of easy money. It is difficult to insist on ⅜ per cent from the British government if you have recently lent at ¼ to the French, or on ¾ per cent from Portugal after agreeing to ½ per cent from what Portugal regards as a comparable credit. Similar problems, but perhaps less frequently, also arise with corporate loans.

Therefore banks look more to the total return, including fees, rather than just the interest spread, so that banks check the level of fees as closely as spreads; this leaves less for the managers or costs the borrower more. When money is easy, the managers may take a larger share of the loan themselves, thus keeping more of the fee and a tighter grip on leaks. When money is tight the borrower pays more either way.

There is also an agent's fee, usually payable annually, to cover the mechanical work of running the loan and the responsibility for supervising the conditions, which can become very onerous if the borrower runs into trouble. $1,000 per annum per participant seems to be a reasonable level, except for highly complex credits.

The total cost may thus be slightly above that of a loan from a single bank; for this among other reasons, syndication has lost favour with the largest corporates. When not using some other form of financing altogether, they prefer to raise large loans on an individual basis, sometimes even presenting a group of banks with a loan agreement they write themselves. Generally, however, syndication provides access to a wide range of banks, at a cost which the borrower alone could not match with banks which do not know him well.

The Managers

The functions of the manager and agent, both extremely important in syndication, are often performed by the same bank but are separate and will be separately discussed in this chapter. However, there is some overlap between them and it is not always clear in which capacity a bank is acting.

There are three possible arrangements for management of syndicates. A smallish loan, with a few participants, may have a single manager. In early syndications it was common for even quite large loans to have a single manager. However, a group of managers is now standard for larger loans, with, normally, a 'lead manager'. There may also be a group of 'co-managers', largely a prestige group, taking a large participation and a commensurate fee, but not actually managing. Thirdly, for big country loans, there may be a group of 'lead managers' of equal status who divide the functions among them. This is sometimes called a 'club'. Members of such clubs may underwrite the full amount of the loan, so that the borrower is guaranteed his funds, unlike the more traditional 'best efforts' syndication. (There is an arrangement with much in common with syndication where the borrower negotiates identical deals with a number of banks but one bank (or one for each nationality) acts as 'coordinator'.)

Syndicated lending has a history in several different domestic markets, but only in the US has it been a major factor. As a result there is no generally accepted pattern (although a number of domestic markets, including the UK are now following the eurocurrency market). Thus, in the early days of the market, the functions of manager and agent were not clearly identified; even now the lack of case law causes some difficulty.

It is probably fair if over-simplified to say that in the US the borrower provides information and answers questions directly to lenders, who then make up their own minds. This gives each bank a chance to influence the terms. The manager advises the lender on terms and on the loan agreement, but is not the major marketer of the proposal, although a bank with a reputation for sound credit judgement can help to sell a deal. This approach to syndication probably reflects the fragmented nature of the US banking system with all but the smallest companies having a large number of banking relationships. Syndicating among them is no real hardship, and they probably receive almost as much information in the normal course of business as they require for the syndicated loan.

In most other countries there are traditions either of 'house banks' or of merchant banking advisers with privileged positions. There is no tradition of equality of information, and little information given to lending banks (as opposed to shareholders or advisers). Borrowers thus assume that some banks will have more information than others; many European banks accept this position willingly, but they may take differing views as to the resulting obligations of the manager to the borrower and to other banks. American banks find the idea harder to swallow and the less sophisticated are unaware of the different pressures, legal and practical, on the manager.

There are a number of corollaries to the European approach. In the early days, banks tended to look at the status of the manager rather than at detailed assessment of the borrower. This was sometimes because this fitted their own banking tradition, or sometimes because the American manager was assumed to have full knowledge of his compatriots. The problems of the mid-1970s and early to mid-1980s have made this attitude less tenable; banks, at least formally, now accept that they must do their own credit analysis. Nevertheless a number still rely fairly heavily on the status of the manager. In view of this it is a matter of concern that, partly owing to the practical realities of the market, partly to the excessive desire by some legal advisers to avoid any form of liability, and partly to the variety of different banking laws involved, his moral and legal responsibilities still contain areas of doubt.

Nowadays, agreements mostly require participants to warrant that they have each performed their own analysis of the borrower, received all the information they require and so are not relying on the manager's judgement as a basis for their decision, even though they may also absolve the manager/agent from passing on information acquired in other capacities. In practice, in most large syndicates this is demonstrably not true. Many banks are either too small or too unfamiliar with the borrower to be able to match the analysis done by major banks. In addition, the manager is often the lead bank to the borrower and inevitably in many cases has a more detailed knowledge than most participants can possibly have, or than it is practicable to disclose. Even where the borrower is willing, time pressures usually preclude full analysis by hundreds of banks with all the detailed questions they would have in view of their limited prior knowledge. And the commonsense answer - which is for the manager to circulate his own analysis - raises serious legal problems since he earns a fee and any mistake in the analysis could be considered misrepresentation. The information memorandum thus consists purely of information already public or supplied by the borrower, with no warranty or comment on its accuracy or implications by the manager. (This is the theory at least; in practice a good manager will go to considerable pains to ensure that the borrower provides full and accurate information.) In brief, the market must operate on a basis of commonsense and trust, although agreements do not fully recognise this. Although banks and their lawyers still worry about possible legal action, the market has built up a degree of mutual trust which makes vindictive action unlikely, at least as long as the trust is not seen to be betrayed.

There is a potential conflict between participants' rights and their interests. It is in everybody's interest to ensure the manager's ability to analyse the borrower thoroughly and to obtain all the information he needs for that purpose. If, however, participants insist too strongly on their right to equal information, the result may be a reduced flow of information even to the manager. Thus while participants are at risk and must be able to assess the risk, no banker ever makes a loan knowing as much about the borrower as the borrower's management. Banking skills include judging when incomplete information is sufficient for a sensible decision. In that context, the knowledge that the managers are sophisticated and responsible banks, who will certainly not conceal negative information, can provide a small but legitimate input to the decision. The direct information must suggest that the loan is sound and fits the participant's portfolio, business objectives and philosophy of risk.

Most responsible managers will try to exclude unsuitable participants from loans of unusual complexity or risk. To put it crudely small US regional banks should not be invited into UK property or Norwegian shipping. But nor should they seek invitations into such loans. A manager must analyse the borrower; to suggest that he should also analyse the lenders is extending his responsibility too far.

The Agent

The lead manager (or one of them) is usually also the agent and negotiates the detailed loan agreement. While he consults closely with the other managers on the agreement, in the eurocurrency and most European domestic markets the participants have little say on matters of substance, although changes of detail can be negotiated and banks can (and occasionally do) drop out of the loan if the agreement does not meet their requirements. Where the agent does not actually negotiate the loan agreement, he will still need to approve the operational parts in detail.

It is now established that the manager's function ends once the agreement is signed; only rarely is the management group resuscitated to handle problems. In all other cases, the agent takes over.

The agent's function is to operate the agreement once it is signed and in this respect its duties are clearcut in principle even if often complex in detail.

(a) The agent checks that conditions precedent to the signing and to drawdown or rollover, where appropriate, are met,
(b) and then issues notices of drawdown and collects funds from the syndicate for payment to the borrower; sets the interest rate by the agreed method; calculates and collects the interest and repayments of principal for distribution to the participants.
(c) The agent checks the provision of the original collateral; updates valuations and procures the delivery of any additional collateral necessary to maintain cover; and ensures full insurance in which the syndicate's interest is noted.
(d) The agent also monitors appropriate items in the loan agreement. These include delivery of annual and interim reports or other information; the receipt of certificates of compliance from the borrower or an independent auditor, the receipt of information necessary to check compliance with covenants. The agent either distributes this information or advises the syndicate of compliance based on any necessary calculations or both.

There are a number of minor judgements often left to the agent's discretion, such as whether a particular auditor, valuer or insurer is acceptable or whether specific collateral is in accord with the loan agreement. At one stage it was quite common for the agent to have a fair amount of discretion on items such as substitute collateral or even whether to enforce events of default, but the tendency has been to reduce discretion, and make the agent little more than a post box for advising the syndicate, calling meetings and carrying out the syndicate's instructions.

The loan agreement and/or a separate agency agreement will spell out the events of default and in what conditions the agent can or must demand payment, realise the collateral or call the guarantee. There will also be provisions for the agent to waive an event of default. The agent's discretion to act, or the percentage of the syndicate which must or may give certain instructions, will be specified. As the risk, both of responsibility and of misuse of power, became apparent, agents and participants combined to reduce it. Some banks feel that the pendulum has swung too far and that an agent has an irreducible element of fiduciary responsibility, whatever the agreement says. Moreover, a number of lawyers are doubtful whether blanket exclusions of responsibility will be supported by the courts.

In practice, after all, the agent usually has a large exposure in the loan and is likely to be agent at least partly because of his knowledge of the borrower. It is therefore something of a nonsense to rob the syndicate of the benefit of his knowledge just when it is most needed.

The question of equality of information arises once more. The agent, like the manager, may well have to distinguish which information is received as banker to the borrower, and therefore covered by the rules of confidentiality. Additionally, in a marginal situation the security risk may be crucial. A company teetering on the edge could well fail as a result of illtimed press publicity and in the view of many bankers a syndicate is virtually guaranteed to leak. If the agent distributes all the information regardless, he risks damaging the syndicate to protect himself. In addition, the point about providing information confidentially or not at all applies as much to the agent as to the manager; the agent needs information, and the borrower advice based on it, if the syndicate's interests are to be most effectively protected.

None of this means that an agent should withhold information without good reason but only that he should be allowed to judge what is good reason. Where banking confidentiality applies, the borrower's permission can be obtained to disclose; certainly no syndicate should ever be asked to take major decisions on incomplete information. Indeed a good agent will keep a stream of information flowing to the syndicate and will consult members wherever reasonable whatever the legal requirements. A well informed and active syndicate can take better decisions and provide a better check on the agent's views than one confronted with an indigestible mass of information and asked for an instant decision.

There are only a few cases where the banks can decide a borrower's survival and a few more where the right decision on calling a default or pressing the borrower to take specific action can significantly affect the recovery from an insolvent company. Both cases call for a high quality of banking judgement often applied at short notice and/or on a continuing basis. This type of judgement needs detailed understanding of a situation and quick responses, both quite impossible for a large syndicate.

There are many more cases where the main responsibility for saving the company remains with its management, but the banks must continuously assess its effectiveness. In some workout situations the syndicate may need to put in new money. This requires a unanimous decision which is certainly not possible unless the syndicate is confident of the borrower and the agent; and of their working relationship, which more restrictive agency clauses strive to undermine. More likely is the need to waive (or at least not actively enforce) rights or events of default under the agreement. While the initial decision will usually be taken by the syndicate, there is a continuing need to review progress. Banks will accept such inaction only if they are satisfied that their position is, at worst, not deteriorating and has some commercial chance of improvement. But to remain satisfied can involve an enormous amount of detailed work and – particularly where new money is involved – may require a series of small decisions which are almost of a management kind. For instance, if operating costs of a ship are being paid out of charter hire pledged to the syndicate, the agent may review each payment to ensure that it is essential.

The agent will of course keep the syndicate closely informed and certainly take a vote on major decisions. But the whole syndicate cannot possibly be closely involved in all the running judgements and must therefore rely on the agent to get the very delicate balance between being hard nosed and constructive right. In a large syndicate, a sub-committee (perhaps the original managers) may meet more frequently than the whole syndicate can. Alternatively, if the borrower has borrowed from several syndicates, it may be best for all the agents to form a committee among themselves. In either case, however, the primary responsibility remains with the agent.

The agent's detailed involvement with the borrower creates potential conflicts of interest, since the agent is quite likely to be agent to other syndicates, or to be lending alone, or both. He may be lending unsecured and the syndicate secured or vice versa. And there is real doubt under several countries' banking laws whether the agent is entitled, against the borrower's wishes, to release information received in his capacity as banker rather than agent, even if it evidences an event of default under the loan agreement. Certainly English solicitors advise extreme caution in such a situation. Elsewhere, for instance under US law, the overwhelming obligation is to inform the syndicate. However, what matters is probably the law under which the banking relationship exists and a conflict between this and the law of the agreement can be insoluble without goodwill. It is desirable to distinguish conflicts of interest which have substance from merely latent conflicts. In the latter, it may be sufficient for the syndicate to agree in writing that the agent should continue despite the potential conflict; or in special cases in full knowledge of a substantial conflict. If the syndicate does not agree, or if the agent feels that the conflict is so serious that he cannot continue to act, there should be arrangements under which he can be replaced in an orderly fashion which protects the syndicate.

However, the more restrictive view has gained general acceptance in the market. It is now standard for the agreement to allow the agent to resign at any time, on notice that may be as short as 30 days. Unless the borrower and other banks can agree on a replacement the retiring agent often has the right to appoint a new one; sometimes his choice must be a first class international bank active in the euromarkets, or some such phrase. Often even that is ignored.

The competence of the agent even in favourable conditions is important, but in difficulties it is crucial and banks prefer to lend where there is a strong agent (and in difficult conditions may refuse to lend if they do not like the agent). There is some concern at the practice of central or nationalised banks acting as agents for loans to their own governments or governmental institutions. Finally, while there is general agreement that the agent should always be a member of the syndicate, there are cases where he need not be a manager.

Concern about the agent's risk in handling payments in both directions arises from the time difference between Europe and New York. Even where both borrower and lender are in Europe the agent cannot know funds are in his account before paying out, unless he delays payment one day. The agent must pay promptly on receipt, but there is no obligation to pay funds not received. In the great majority of cases funds are received in time and to wait for certainty costs the recipient a day's interest. The choice is to pay automatically in all cases, but expect that the syndicate will refund if receipt is delayed; or to pay only if the credit standing is satisfactory, otherwise to delay until receipt is known. The agent is responsible to the syndicate for lost interest unless payment follows promptly on the actual receipt of funds. Awkward cases occur where funds are received but the agent does not know it for some time (perhaps because of faulty instructions or credit advice by an intermediary). A New York bank may offer interest at New York money market rates since the funds will have been used there. If the agent is not a New York bank and has simply had an unknown, and therefore unusable, credit balance on its current account, it may not feel able even to do this. Most agreements now allow the agent to withold payment, but also to recover any payments made in good faith and not covered.

The conclusion drawn from these and similar points by many banks is that the function of the agent - and to a lesser extent of the manager - probably cannot be covered in full detail by any workable agreement. It must depend substantially on trust and responsibility between banks who have broadly the same interest and who understand each other's attitudes; after all, the agent/participant relationship may be reversed on the next loan. Too much pseudo-precision, or too legalistic an attitude by either agent or participants substantially reduces the effectiveness of the agent in his function of protecting the syndicate's interest.

The lack of common interest and known attitudes is largely responsible for the reluctance of commercial banks to enter syndicates led by investment banks who are often primarily acting as the borrower's adviser. (This worked against the UK merchant banks initially but is is now generally accepted that they are serious lenders in relation to their resources, and competent agents.) An investment bank, with no loan to protect, is considered more likely either to put its duty to, or its relationship with, the borrower ahead of the syndicate's interests. The hardest thing in deteriorating situations is to persuade the management of the need to take drastic action in time. A commercial banker protecting his own loan can fail, or even miss the seriousness himself but at least he has a major incentive to get it right. An investment banker lacks that incentive. In more general terms, banks like to feel that the manager is not just pocketing a fee and lightly passing on.

The market seems to have found an acceptable compromise between the orignally rather too relaxed attitude of the London market and, in its more extreme versions, the legalistic American approach. Trust need not mean lack of interest, or involvement, but nor need interest mean continual questioning of the agent, or picking him up on small points. Both attitudes still occur, but are less common than in the early days of the market.

The two situations which did most to focus the market's attention on the risks of the manager/agent, and on the dangers of conflict of interest, were the Colocotronis/European American Bank (EAB) case and Zaire.

EAB made a number of loans to single ship companies in what was known as the Colocotronis group. The loans were secured by first mortgages on ships and assignment of their charter hire, and guaranteed by Mr E. M. J. Colocotronis and various members of his family. EAB then invited participations in the loans; in this form of syndication the manager makes the loan, and then sells shares in the rights and obligations arising under it to other banks - sometimes some years after the original loan is made. Participation agreements have important legal and procedural differences from the more common form of syndication, but the general principles governing relationships between lending banks are the same.

When the Colocotronis group defaulted on its loans, several US regional banks sued EAB (as did the Colocotronis family). While some of the complaints were fairly specific, and if accurate were certainly outside the normal relationship between manager and participant, they raised two questions which the market took to heart. First, they claimed that the sale of participations came under the US Securities Act of 1933 and the Securities Exchange Act of 1934. Whatever the legal force of this claim, the market was appalled at the idea of bank loans having to conform with US securities laws. Secondly, the market's impression was that a large part of the plaintiffs' case could be summed up as follows: 'EAB said it was a sophisticated shipping bank and knew all about Colocotronis. We are just poor country cousins, and we believed EAB and lent on their say so'. This cut right across the argument about a bank lending its own money, and left active syndicating banks with the fear that if EAB lost a whole new element of risk would have come into the market. The case was eventually settled, but in a less publicised case in New York, a court ruled that a loan could come under the securities laws and that some banks could be considered to need protection under them. The net result was lengthy protective clauses in agreements.

Zaire ran into default on its bank debt late in 1975. While a group of agents for syndicated loans were negotiating to get Zaire back onto a regular payment basis, they learnt that the US Exim Bank was arranging a new loan to complete a major copper project. The terms provided Exim Bank with a prior claim on the revenue from the project not merely to service its new debt but also existing debt; this priority was also to be granted to certain syndicates involved with Exim Bank on these loans. Citibank was agent to one of the preferred syndicates and to another which was not preferred. Since the preference apparently violated the negative pledge (see Chapter 7) in most of Zaire's agreements, Citibank and Bankers Trust sued Exim Bank to prevent them signing. While the situation had a number of interesting points, the most relevant is Citibank's conflict of interest as agent/beneficiary in one syndicate and agent/plaintiff in the other. It was generally understood that Citibank came under severe pressure with threats of suit from the plaintiff syndicate. (The Exim Bank suit was subsequently settled.)

Finally, the borrower too has to consider some of these factors when choosing his manager and agent. If he runs into trouble, he will need an agent who is tough enough to tell him so, and imaginative enough to recognise constructive actions as well as risks and to carry the syndicate with him. In practice this is unlikely to be a major consideration in most borrowers' choice of a manager/agent; they naturally foresee no problems in repaying the loan. Nevertheless, the choice is important for other reasons, particularly to a smaller or less sophisticated borrower with no established relationship with a bank active in this market. A small company does not necessarily need a giant bank, there are a number of banks with special interest in smaller companies or specialised knowledge of certain industries which have the reputation to carry a syndicate with them. It is difficult for a borrower to judge this reputation and he may have little option to basing his judgement on the people concerned. Where there are a number of banks seeking business, he has a choice of approaches.

He can pick one bank as adviser/manager and allow it considerable influence in structuring the best deal for both parties (which requires confidence that the bank will not overcharge him or make other conditions more onerous than they should be), or he can put a mandate out to bids. The winning terms may turn out to be more favourable than the mandated bank can market and new terms may have to be negotiated. These may be less favourable than those offered by the runners up, since by this time it is probably too late to go back and the borrower is virtually committed to one bank. One solution (an underwritten bid) will be available only in favourable markets and in an amount which a single bank can reasonably be expected to commit to that borrower. The other danger, particularly in an easy money market, is that the amount or the terms or both, may be more favourable than the company should accept. The criticism which arises in easy money markets (1972–3 and 1977–8, for example) is that banks offer more money on easier terms than the borrowers can safely use. The corollary is that borrowers who take more than they should undermine their own viability. A bank which limits the amount it will lend and requires tighter conditions may therefore be offering sounder financing than its more 'imaginative' rival.

The borrower should consider these points very carefully before choosing a bid, particularly from a bank which will not be taking a large amount of the loan itself. Countries and companies borrowing for the first time, and without established commercial banking connections, may be well advised to appoint a consultant to introduce them to the market. This might be an investment bank, clearly acting as adviser only, or a commercial bank which might thus have the inside track for the mandate, but be expected to submit to competition.

Techniques of Syndication

Whatever the borrower's choice of syndication method, a potential lead manager needs to judge the approach carefully.

The first step may be to pull together a strong management team, with a spread of market standing, technical expertise and geographical coverage. The detailed implementation of the remaining steps depends on the nature and size of the loan. Loans can be of three types.

Fully Underwritten

The manager(s) undertake(s) to provide the full amount of the loan if necessary. However, each manager also has a smaller figure in mind which he intends to keep; he hopes to 'sell down' the balance in course of syndication.

Partly Underwritten
The manager undertakes to provide a substantial amount, but less than the borrower requires; he obtains the balance only if syndication is successful.

Best Efforts
Here, the manager is prepared to take up his amount only if syndication is successful; his share is substantially less than the borrower requires. If syndication is unsuccessful, the borrower gets nothing. Until 1977, this was far the most common form of syndication, and it probably will be again when money tightens, but in the competitive markets since 1977–8 underwritten loans, which are usually more attractive to the borrower, have been more common.

The aim, in all cases, is to set terms which attract large enough participations to make the loan a success, but which are still fine enough to win the mandate. In deciding what terms are right, it may be necessary to tap a wide range of knowledge as to banks' interests in different types of borrower and deal.

The nuances of the terms vary depending on whether the loan is underwritten, but the principles do not. The managers must be prepared to accept the maturity, amortisation, grace period, covnenants, etc. themselves as lenders, and be satisfied that the market will agree; failing this they may have to keep a larger share of an underwritten loan than they wanted. A failure to complete a best efforts syndication is likely to damage a bank's reputation, quite apart from loss of fees. Failure may sometimes be redeemed by returning to the market with more generous terms, but this is generally poor practice. Frequent renegotiation damages a bank's reputation and ability to syndicate. And of course either an outright failure or a re-negotiated success risks undermining the relationship with the borrower which, for many banks, is as important as either of the other factors.

Once the mandate has been awarded and outline terms agreed, the manager(s) have to take the necessary steps to bring the deal to market, and complete it. This involves four steps, some of which are often taken simultaneously.

(a) Preparation of a term sheet, to summarise conditions, including the scale of fees for various levels of participation, and brief details about the borrower. This is delivered (usually by telex) to:

(b) A list of potential participants to enable them to indicate preliminary interest, in which event they receive:
(c) The placing memorandum, which describes the borrower, the transaction and the terms and conditions of the loan in more detail. It provides information on the nature and credit standing of the borrower, including balance sheets, profit and loss statements and perhaps forecasts for corporate borrowers; and information on the domestic economy and resources and external balance for countries. Although this is often prepared by the borrower, a good manager will review it carefully to ensure that it is accurate as far as he can tell, complete, and to the point. He will, however, be careful not to include any endorsement of the credit or views as to the information, for reasons outlined above. From the placing memorandum and after asking any questions, an interested participant makes a provisional commitment, subject to satisfactory documentation.
(d) Negotiation of the loan agreement.

Once the terms have been set, the initial presentation by term sheet is sent out to a selected group of banks. A borrower may indicate banks he wants included because of existing relationships, but it is an important part of the manager's function to keep in constant touch with the market and know which banks are interested in, or full up with, the country or industry concerned; which will not lend below a certain margin and/or rather like to take a slightly extra risk for a higher margin, or a larger participation for a good share of the fee; which are sufficiently sophisticated to be shown a difficult loan and so on.

The rate and fee package is even more delicate; the distribution between managers and participants must be correctly judged as well as the total cost to the borrower. The managers' entitlement is in equity affected by the extent to which the loan is underwritten, the amount of work involved in structuring the loan, the degree of risk to their reputation. Subject to these factors, the managers naturally want to keep the maximum for themselves but if they are too greedy the syndication may fail or they may lose the mandate.

While there may be management or participation fees, or both, usually the lead manager requires a praecipium based on the whole amount; the co-lead managers receive a high fee on what they underwrite or take, while participants receive a percentage on their share, which usually varies with the size of the participation. Thus, depending on the final mix of participations, there should be a 'pool' left unallocated, which the managers share. A typical division of a 1 per cent fee on a large loan expected to be difficult to syndicate might be:

⅛ per cent praecipium to lead manager (on the whole amount)
⅞ per cent to each manager on the amount he takes, say, $20 million
⅝ per cent to participants taking 10 million or over (on the amount each participant takes)
½ per cent on participations between $7 and $10 million
⅜ per cent on participations between $4 and $7 million
¼ per cent on participations between $2 and $4 million

and a pool for the managers. If the whole loan were provided in participations of $15 million each, there would be a pool of ¼ per cent on the amount not taken up by the managers. In practice, there will probably be some participants in all three sizes, and a larger pool. (The proportions are still about right and 1 per cent is easier to split up, but in the competitive markets of the mid-1980s the actual levels would be measured in basis points (1/100 of a per cent), not fractions of 1 per cent.)

Some banks will refuse a participation in a large loan, tightly priced as most large loans must be in competitive markets, or take less than hoped, and more banks must then be approached.

One of the managers therefore keeps 'the books', a record of who has been approached, their response (if positive for how much and subject to what conditions), and a running total of the amount raised in syndication. This can be a complex operation in a large syndicate where perhaps the managers have divided the list of banks between them - the American manager may approach US and Canadian banks, the German manager continental European banks, and so on. In difficult syndications over 100 banks may be approached for ten or fifteen acceptances. Where the amount being raised is large (say $500 million upwards) the eventual syndicate may include over 100 banks with perhaps two or three times that number approached.

Given a preliminary indication of interest, a formal presentation is made to each bank. In a small syndicate, or one where all the potential participants are in one city, the managers may present the placing memorandum themselves and answer any questions on the spot. Where participants are more widely scattered, the memorandum will be posted and questions answered over the telephone.

If syndication is successful, the amount offered may be more than the borrower originally required. If so, either the total amount can be raised, or the amounts requested by each bank are scaled down appropriately. It is quite common for the managers to go to market hoping to be able to increase the amount, but there are also many loans where the borrower declines any increase. There is some question as to whether banks which have accepted a participation in a $100 million loan are still bound when the loan is increased to $200 million; the implications for the credit may be quite different. But where it is clear that the borrower will take more if he can get it, there should be no objection.

If it is thought that the details of the loan agreement are likely to be a serious factor in the final credit, syndication may not start until at least a first draft has been discussed with the borrower. However, since the negotiation of a loan agreement can be a lengthy procedure, it is increasingly common for this to take place during the syndication, and sometimes drag on for some time afterwards. No bank is fully committed until it has seen and agreed to the documentation, although the placing memorandum should indicate any unusual features. Documentation is sufficiently standard so that in practice objections are rare. However, on receipt of the first draft, a bank may indicate that a particular feature is unacceptable, and reserve the right to drop out unless it can be changed. Usually it can be modified to everybody's satisfaction, but if it cannot (which is sometimes clear only at the last moment), any bank is entitled to withdraw with no hard feelings, provided it had previously made clear that the point was vital.

Although for a small syndicate all the functions are often performed by one bank, in a large syndicate they will often be split. One will be agent, one negotiate the loan agreement, one prepare and distribute the placing memorandum, one keep the books, another handle the closing.

A feature of the very competitive markets of the late 1970s and early to mid-1980s is that the skills of syndication revolve very much around price and cost. In a tighter market the assessment of credit (and structure of a loan to ensure the soundest possible credit) is much more important.

The advantage is the much larger number of banks who can share in the fees and profits - although the ability to take a large participation is almost as important, and gives a clear advantage to larger banks. This larger number of players also gives the borrower a wider choice and opportunity to obtain more favourable terms.

The disadvantage is the increasing impersonality of the syndication market, with borrowers switching managers for a marginal cost advantage, and banks being deluged with telex offers of participations. Many bankers, and some corporate treasurers, believe that this has reduced the value of the relationship between bank and borrower which can be so important both in attaining and maintaining a creditworthy package. This is in addition to the general risk of slippage of credit standards in slack markets discussed elsewhere. A weakening of the trust and understanding between banks, if it occurred as a result of the trend to impersonality, could also exacerbate some of the problems discussed earlier in the chapter.

MODERN FORMS OF MULTIBANK LENDING

As mentioned in Chapter 1, new forms of lending are developing in a process often described as the securitisation of lending. Some of these (the Floating Rate Note, for instance) are almost wholly capital market instruments. Others, such as interest rate and currency swaps, are not strictly lending themselves, but are means of changing the form of lending, thus gaining greater flexibility.

The direct descendants of the syndicated bank loan are the facilities known as RUFs, NIFs and MOFs. There are many forms of this new species (which is still evolving), and each bank has its own pet name, but the main features are clear.

RUFs and NIFs operate in broadly the same way, with one exception. In each case, a group of underwriting banks commits to lend in a prescribed form and for prescribed periods (usually advances for three or six months) at a maximum cost to the borrower. This cost will be a margin (expressed in basis points) over a market rate, such as LIBOR. However, this form of borrowing is a fall back only; the main form of borrowing is by means of negotiable notes, which are put out to auction. The auction mechanism differs; with a NIF there is a tender panel (TP) of banks who are often also underwriting banks; with a RUF the (investment banking) manager of the facility bids alone at a price at which it can place the notes. Since the placing of the notes attracts fees but carries no continuing credit risk, commercial banks are keen to share the fees through a TP. Investment banks claim that since only they have the distribution channels, a TP adds to the cost.

Some borrowers dispense with the underwriting banks altogether; they appoint one or more dealers (who may be a mixture of commercial and investment banks) to place the paper. They then either rely on other committed facilities if the market in notes should dry up, or perhaps use it only for genuinely fluctuating needs. Either way, they forego the medium term commitment associated with a NIF or RUF.

A MOF works in the same way as either a NIF or RUF, with one additional feature. The borrower can call on the underwriting banks (or sometimes the TP) to lend in various ways other than the advance or sale of notes. The banks are not committed to lend in these ways; if they do, some agreements count this as usage under the commitment, others do not. Methods of borrowing include advances over LIBOR, at prime or over dollar CD rates, dollar and sterling acceptances, and sometimes other currencies. Sometimes there is a special TP for acceptances or some other instrument.

These methods of lending may have a relatively short life. Introduced in the early 1980s, they have attractions for the borrower; however, the underwriting banks put enormous commitments on their books, which are likely to be used only in unfavourable circumstances. Until then, the only earnings potential is from arrangement and commitment fees. Major banks, whose commitment should be most useful to borrowers, are reluctant to accept the risk for such a low return; this reluctance is compounded by a growing concern among regulators that all the commitments may come back onto the banking system's balance sheet at once. The Bank of England and Bank of Japan imposed capital adequacy requirements on commitments for NIFs and RUFs in 1985; other central banks, led by the BIS Group, seem likely to follow suit, unless the banks can achieve more sensible pricing. In early 1987, the US Federal Reserve and the Bank of England published a joint proposal on capital adequacy which included specific requirements for capital to cover unused commitments. They hope other central banks will follow the same approach.

Documentation is also a worry. The basic principles are the same as for a medium term loan, as described in Chapter 7, with two important modifications. The mechanism of borrowing requires careful description, but should not be contentious. The allocation of risk in case of default is much more important, although the market does not yet seem to have focussed closely on it.

The underwritten portion normally has default clauses which allow the underwriter to refuse to lend. Because the initial users of these instruments were either sovereigns or first class corporates, the default clauses tend to be minimal; in particular there were at first no ratio covenants, and they are still rare and weak, even with the few lesser credits which have so far used this market.

It is thus likely that the market will refuse a credit, and require the underwriters to lend, before there is a default. Nevertheless, default could occur unexpectedly during an interest period; in this case, the pressures on the underwriting banks – and the risks for the borrowers – are entirely different from those in a normal loan. Where a bank is already lending, precipitate action often merely increases its chance of loss; it will thus normally want to work with the borrower to solve the problem rather than accelerate it. A bank which is not lending, but may shortly be called upon to do so, is much more likely to call early default on a weakening credit. This may precipitate an unnecessary liquidation for a company, or a debt crisis for a country.

Even where the borrower avoids this extreme situation, a managed restructuring of the debt becomes harder. Yet this is often the best solution, particularly where the borrower is based in a country with inefficient or corrupt bankruptcy laws. *How to Handle Problem Loans* stresses the difficulties of a restructuring with a large number of banks, many of whom have had very little contact with the borrower; dealing with them is often the hardest part of the whole process. Replace non-relationship banks with note holders, many of whom may not be banks at all; ensure that none of the relatively small number of large banks who have the experience and resources to manage a restructuring are major direct lenders; have the facility underwritten by banks whose own status may not enable them to survive the publicity of a major bad debt; and you have, at least from one point of view, a recipe for turning a minor hiccough in a borrower's progress into a major disaster.

Weaker borrowers are thus unlikely to be able to use the NIF/RUF/MOF market, and arguably would be unwise to do so anyway. Stronger borrowers are unwilling to pay a high enough commitment fee to ensure that only strong banks underwrite their facilities, and may not consider weaker banks' commitment worth having. AAA rated corporates and sovereigns can already raise money more easily and cheaply than many small or medium banks. The logic of this is behind the direct approach to the commercial paper market (US or euro), using banks only as placers and dealers in the paper, as mentioned above.

Nevertheless, whether or not NIFs, etc. survive in their present form, they warrant discussion. They have transformed part of the bank lending market into an insurance market. In doing so, they have changed the nature of the risk, the reward and the risk - reward ratio in ways that the market is proving slow to understand.

There has of course always been an element of insurance, of availability or price or both, in most bank facilities; revolving commitments, described in Chapter 2, are specifically designed for that purpose. However, with previous types of insurance, any borrowing was with the bank which provided the insurance, and the commitment fee ensured that companies did not carry massive unneeded commitments. In other words, the banks were adequately rewarded; usage was spread over a cross section of conditions, both favourable and unfavourable from the bank's point of view; and unused commitments were a relatively minor percentage of the banks' balance sheets.

NIFs and RUFs, however, allow borrowers to borrow from other sources than banks; they do so at prices which, even after paying the nominal commitment fee, are cheaper than the banks could match. Thus during favourable conditions the banks earn too little to build up (or service) the capital base they need to carry the loans on the books; if all or most of the commitments are then used at the same time the impact on banks' capital adequacy may be dramatic. Borrowers might face market doubts about their credit, or a change in market conditions might push the cost of issuing notes above the backstop levels. Notes could become expensive, either because of a market concern about weakening credit generally, not confined to one borrower, or because of a loss of liquidity by the normal investors in the paper. A general reduction in corporate cash flow or liquidity might also cause customers who had previously invested in euronotes to cease doing so and start to borrow themselves instead; the double call on the banks could be painful. Or more attractive market instruments may push up the price of NIF/RUF notes to a level where the backstop is triggered.

Some of the same points relate to the other major development of the early 1980s in multibank lending, the loan sale programme. Banks have always sold off parts of some loans; sometimes it was a form of syndication, sometimes a favour to correspondent banks who had no direct access to the borrower. But until the 1980s loan sales were not a major factor in the market. There were legal difficulties in making loans negotiable rather than transferable; the most effective form of transfer required the borrower's consent and might damage the relationship; and throughout the 1960s and 1970s most banks were anxious to increase their earning assets, rather than sell them.

Declining margins, concern about bank profits and capital adequacy and developing credit problems in various areas and industries changed all that. One response was to develop transferable loan certificates (TLCs) which were issued as part of the original loan and were freely transferable. They do not seem to have caught on; the more common approach now is simply to ensure that the wording of the loan agreement, perhaps including the provision of notes, simplifies subsequent sales.

There are two ways in which a loan can be sold. One is to sell a per centage (up to 100) to maturity; the buyer thus has a pro rata share (and the seller reduces its share) in all rights, risks and obligations under the loan, and the position is clear cut.

The second is to sell what might be called a horizontal strip, rather than the vertical one just described. If, for instance, the loan calls for six-month interest periods, a bank might sell the loan just for the current six months. This helps treasury management and profits; however it leaves the seller with a commitment to lend at the end of six months which, at least under American accounting practice, should normally be footnoted on the balance sheet, and subject to regulatory or capital adequacy requirements. Banks, under US practice, can avoid this if they can demonstrate that the obligation to lend is conditional, not absolute. To do this, US banks are introducing changes into their loan documentation.

For instance, even in a fixed term loan, they call each new interest period a new loan; what was a rollover is now a refunding borrowing. The representations and warranties must all be repeated before each reborrowing. If the borrower cannot repeat them, the purchaser may find that his six-month purchase has turned into a medium term loan, or has drawn him into a debt restructuring. Of course, in practice the selling bank may well have other exposure, a close relationship and confidence in the management; to say that it need not lend is not to say that it will not. Nevertheless, the balance of pressures is different.

To reinforce the lack of absolute obligation, banks may also be stricter about ratio and other covenants than previously.

These changes appear to be acceptable to the American market, but it is not clear whether they will be in others. Nor is it clear how other regulatory or accounting bodies will react to banks treating loan sales as off balance sheet, or to the customer still showing them as long rather than short term debt. Indeed, the US authorities in 1986 began to show signs of taking a stricter view.

Other forms of securitisation include the packaging of secured loans, and selling them. This has been done for years with residential mortgages in the US, often as part of a government support programme (Federal National Mortgage Association or Fanny Mae). In the early to mid-1980s this market began to expand in two ways. First, the securitisation of mortgages spread to the UK domestic sterling market; secondly, other types of secured loan (cars, consumer products, etc.) are being packaged, or at least the market is talking about packaging them. It is too early to tell just how far this process will go, but it seems unlikely that it had reached its limit by early 1987.

Indeed, in a broader context, the same comment applies to securitisation generally. New products, and new variations, are bursting onto the market so fast that it is impossible to tell which are soundly based and will last, and which are ephemeral. It is also impossible to make a reliable estimate as to how far the trend to securitisation will go. It may already have gone further than is sustainable in the long run, although even then it could still go somewhat further before the pendulum swings back; or it may still have further to go.

There are, however, some pointers in the form of problems or questions which the market – borrowers as well as lenders – will have to answer. The nature of the answers, when they become clear, will point towards the level of securitisation which can be considered permanent and well established. (For the avoidance of doubt, as the lawyers say, it is clear that securitisation in some degree is a permanent feature; the question is one of market share, not survival.)

The key questions relate to the legal aspects; the philosophy of an underwriter; the impact on banks' balance sheets; the quality of credit able to securitise its debt; the relationship aspects; the end market; and the combined effect of all these in a crisis.

Legal Aspects

There are two points relating to legal aspects. One is that commercial banks are moving into areas covered by securities laws, of which they have little previous experience. Different countries' laws vary widely in the burden they place on the issuers and underwriters of securities as well as how they define all three. In almost all cases the requirements are more onerous than those covering syndication among lending banks. Secondly, who bears the credit risk if a borrower goes into default in the middle of an interest period - the underwriter or the noteholder? the seller of a horizontal strip or the buyer? The simple answer ought to be that if the borrower is in default, the underwriter/seller can refuse to lend. But not all agreements make this clear; the market almost certainly has not taken this on board. Even where the legal position is clear, the underwriter/seller may not know of the default until just before, or even just after, the crucial date and may therefore have to make a difficult decision with no time to consider or negotiate; and some countries' laws may not recognise the validity of some events of default anyway. Until the first few cases are tested in court, it is very difficult to judge what would happen, and who would be responsible. The danger is that everybody will be so busy trying to duck that nobody will deal with the problem.

Philosophy of the Underwriter

The philosophy of an underwriter is different to that of a lender. While reputable underwriters recognise that their reputation will suffer if their offerings run into trouble, their main concern is to ensure that the investor has full information on which to decide whether to buy. Once a security is sold, the underwriters are no longer at risk. A lending bank, however, even in a syndicated loan, keeps a share of the risk throughout its life; if anything goes wrong it has its own money at stake and every incentive to work to save the borrower, and its fellow lenders. Or at least this was the case before securitisation; with both the NIF/RUF and loan sale programme commercial banks are increasingly arranging facilities in which they do not intend to participate. And yet the larger, better known banks often have a reputation for sound credit judgement and management which may influence the decision of possible investors. Commercial banks therefore have to decide whether they will underwrite (which can be defined to include lending solely in order to sell the loan) where they do not wish to hold any part of the resulting paper.

Although each bank will answer this question in its own way, the best banks seem to distinguish between the terms of the deal, and the underlying credit. These banks will not underwrite a borrower whose credit they would not accept at any price. On the other hand, they see nothing wrong in advising a creditworthy customer that the market offers a narrower spread than they are themselves prepared to offer; nor arranging for the customer to get the benefit of the market rate without accepting it themselves.

A loan sale programme follows the same principle, but has some features which require careful consideration.

First, there is no prospectus, and the selling bank may (through a close relationship with the borrower) know more about its affairs than the buying bank. Although the Comptroller of the (US) Currency has ruled that the onus to obtain credit information is on the buyer, not the seller, his jurisdiction is restricted to US banks, and does not even cover all of them. It is not clear that other regulators, or courts, will agree. The selling banker thus has to be extremely careful not to sell a weak credit unless the buyer is as well informed as he is.

Secondly, most loan agreements give the lender protection against imposition of withholding tax or other costs and allow him to demand repayment if the loan becomes illegal. In agreeing to this, the borrower knows the lender's nationality and standing and can assess the risk. Change the lender, and the borrower loses that ability unless he can approve or reject the new lender.

Thirdly, in a syndicated loan, votes on default and other matters require a majority, often 67 per cent or 75 per cent; even with unsyndicated loans, the borrower can expect that banks will have influence roughly pro rata to their holding of its debt. Sell the debt to banks (or worse still non-banks) which have no relationship with or even knowledge of the borrower, and their reaction becomes unpredictable.

Banks' Balance Sheets

The impact of securitisation on banks' balance sheets depends on whether the asset is sold outright (as in sale of a vertical strip), or whether the bank remains committed. In the latter case (including the conditional commitment of a horizontal strip), the initial impact is to remove from the balance sheet an earning asset, and the deposit which funds it. As long as the commitment is not called, the bank appears to require less capital, and therefore it also seems that any earnings on the commitment, however small, add to its return on capital. In both the NIF/RUF structure and the horizontal strip sale the committed/selling bank has the theoretical prospect of being able to refuse to lend, but a probability that the buying bank will recognise a weakening credit before there is a formal event of default. Moreover, the buyer may refuse to re-lend for market, not credit, reasons. The risk is that all, or most, of the unused commitments come flooding back onto the balance sheet at the worst possible moment for the banking system. If capital cover does not allow for the commitments the impact will be devastating; even if they have been given the 50 per cent capital cover required by the Bank of England, it could be substantial. Moreover, if the holders who rid themselves of the assets are not banks (see below) the whole banking system will suffer, rather than just some banks.

The other type of impact on banks' balance sheets arises from the fact that – at least in the early stages – any new product is available only to the best borrowers. Observers thus fear that the banks are losing their best assets but keeping their weaker ones, undermining the overall quality of their assets.

Quality of Credit

Indeed, the quality of credits able to tap this market is of concern in two ways; the one already mentioned and the perhaps even greater concern if it turns out to be untrue. Experience with the syndicated market and some of the earlier products in the capital/securitised markets suggests that once a product is well established, it gradually becomes available to a broader range of borrowers of a lower credit standing. This began to happen with NIF/RUF and loan sale programmes in mid-1985. When the weaker credits start to use a new product, it takes time for the documentation to adjust. Usually, lenders begin to design documentation differently for lower quality borrowers only after the first of these hit trouble, and then they may panic and go too far. It takes time for the correct balance between the interests of borrower and lender to become clear. This process may be even more complex with NIF/RUFs and loan sales; the uncommitted lender and the borrower both want to keep the committed lender in place. Tight documentation – and in particular onerous covenants – may make a loan less saleable.

Relationship Aspects

NIF/RUF and loan sale programmes have potential implications for relationship banking. Usually the borrower gives the business to the cheapest bank, and the bank bids what it thinks the market will bear, regardless of whether it considers this to be in the borrower's best interest. For those corporate treasurers who have always believed in transaction banking, this will seem only right and proper. However, there are corporate treasurers who value their banks' advice and want a relationship in which the bank will tell them that a particular transaction, or pricing is unwise even if the bank risks losing profitable business by doing so.

The more important relationship aspects, however, are longer term. The best corporate treasurers, even where their company is AAA rated, know that in bad times they will need the banks more than the banks need them. For lesser, even though still good, credits this is even more true. These treasurers reject the idea of a major bank arranging but not participating in a NIF/RUF; or making a loan on the basis that it expects to sell all of it at once. They expect banks they deal with to be committed. As long as most major banks will commit for trifling fees, it is hard for treasurers to justify paying more even to the strongest bank. Even those who worry about the strength of the banking system, and sympathise with the stronger banks' views, can rarely do much in practical terms to support their sympathy.

At some stage, however, the corporate market may have to differentiate between the credit of banks, and decide whether it wishes to accept commitments from banks which put too low a value on their own commitment.

End Market

Finally, there is the question of who holds the paper. One idea behind the various securitised facilities was that they opened up new sources of funds to borrowers. The buyers of euro-commercial and other paper might include institutional investors, Middle Eastern or other central banks or government agencies, or European and American corporates, investing their excess liquidity.

(In early 1987 it is not clear how far this is happening.)

Although many banks boast of their distribution capabilities, the general impression is that most paper is held by banks. But if this is wrong, it needs careful thought. A corporate non-bank investor has two main characteristics: he will have little ability to assess credit, and he will invest only his surplus funds only for as long as they remain surplus.

Thus corporates will invest in well known names, and will drop even these if there is even the faintest doubt about their credit. Moreover, the doubt can quickly prove contagious and cause a wholesale withdrawal from comparable credits. Finally, when the investor needs the funds (i.e., they are no longer surplus), it will withdraw them, with no consideration of the borrower's needs.

None of these comments are in any way critical of investors; indeed, to the contrary. The investment of liquid assets is not their main business; it is merely a way of making a slightly higher return while the funds remain surplus. The main reason for having the funds is to finance the business; a corporate treasurer both can and must protect those assets so that they are available when needed, and use them in the business whenever it can do so profitably. No marginal increase in return justifies any risk of loss, nor does a non-bank investor owe any sort of loyalty to the borrower. Indeed, if the investor's liquid position should change, it may quickly become a borrower.

Combined Effects

In summary, the whole issue of securitisation is one which deserves much more thought than most banks appear to be giving it. Most of its development occurred when the major industrial countries were recovering from a recession. Corporate profits, cash flow and liquidity were all on the uptrend, and competition to lend intense. For all its virtues, securitisation introduces a new volatility, a series of new risks and weaker connections between risk and reward or risk and capital. Until the whole package has been tested in recession, we cannot tell whether the banking system as a whole has judged it correctly. There are, however, real fears that at least some banks have got it badly wrong and will pay the penalty.

6 The Organisation of Credit Decisions, Credit Controls and Review

This chapter covers five subjects, closely interlinked but separable for discussion. These are power to approve credit, analysis and presentation of a proposal, monitoring of loans, monitoring the quality of the portfolio, and country limits. Each section describes different methods of approach to its subject and then, after indicating which are most used, tries to identify the reasons.

Different methods of marketing have an important influence on the organisation of credit decisions and controls. There are two main ways to market wholesale services. Using bankers as 'account executives', one or two people are responsible for the whole relationship with each customer, who then knows to whom to turn for help in any problem, regardless of his other contacts or specialist requirements. The banker must understand the full range of services he is marketing and can give to the customers access to the specialists where needed. However, even here he retains the responsibility for seeing that the customer is satisfied and that the relationship is profitable. Most important he is responsible for marketing credit facilities and understanding the credit of the borrower.

At the other extreme, each department is responsible for its own service alone and nobody has personal responsibility for the customer's total needs. Senior management and perhaps certain areas of middle or branch management are responsible only at one remove, and the customer has no one name on whom to call.

Almost all American banks use account executives in the full sense. They differ as to whether clients are allocated by industry, geographically, through a relationship with head office or haphazardly; and as to whether subsidiaries of multinationals are allocated to the local branch responsible for the parent company. Nevertheless in each branch the customer knows to whom to talk and the management of the bank knows who to praise or blame.

The departmental method is used in its purest form by some continental European and British banks. Larger British banks use account executives for major customers; some merchant banks have always had one director responsible for each name, if only because he was the director running the first department to do business with the company. Some banks have 'country desks' and 'desk officers' for their international business, and these have many of the functions of an account executive even when domestic business is handled departmentally. Some London branches of continental banks use account executives even when their head offices do not. Small branches or subsidiaries and some consortia banks probably do not have the same clear cut distinction; their few executives naturally cover all departments and all customers.

Securitisation with its many highly specialised products has changed the detail of both types of setup, sometimes quite drastically, but has not changed the underlying principle.

THE POWER TO APPROVE CREDIT

There are four ways to allocate power to approve credit. Many banks use a mixture of two or more:

1. A credit committee which can be anything from a group of specialists to the main board or management committee, temporarily switching hats; it can cover one branch, a region, the whole international division or the whole bank.
2. Senior specialists, whose duties are entirely related to credit. They may be confined to making credit decisions or include credit control and administration.
3. Senior general lenders whose authority arises from their overall seniority and function.
4. Devolved authority. Sometimes referred to as the 'ladder' method, this can involve any, or any combination, of the first three but at junior levels.

It is quite common to combine these in various ways. For instance, a credit committee may have the senior authority, while lesser authority is granted to individuals. Some banks have a credit committee in overseas branches but not in head office, some vice-versa. Moreover, the practice may not follow the official procedure so that a dominant member of a committee may effectively exercise sole lending authority; a committee may act as a forum ratifying the decisions of trusted members; or a senior lender may consult so closely that he almost creates a committee.

Where individual limits are granted, many banks require at least two signatures, a few even three; usually the authority of the senior decides the limit but sometimes two or more limits may be combined. It often requires two senior lenders (in some banks a director and a general manager) to commit the bank or branch to its maximum limit, although each has a lower personal limit as well. This could almost be said to be a committee but it is not considered as such.

A trend seems to be growing for banks to segment authority by the complexity of the decision or the riskiness of the loan, as well as by amount. A small but growing group of banks apply a rating to all their credits; some then make it easier to approve high rated credits than low ones. There are at least three slightly different approaches. One uses a matrix, so that who can approve what can be read off a chart, combining rating with amount. Another allocates specific combinations to each individual, so that A can approve up to $\$x$ million for a borrower rated 1–3 but only $\$\frac{1}{2}x$ million for lower rated names. And the third requires all names rated below investment grade to be approved, for amounts above a specific limit, by the highest level of lending authority. Most banks moving in this direction also require specialist approval of loans in areas such as shipping, property, energy and other specialised areas, although often this is just formalising normal practice,

The ratings may be set by an analytical department, or by the lending officers, In the latter case, they will be carefully checked for bias.

Practice seems to be fairly evenly divided between a credit committee and senior general lenders at the most senior level. Except where the board or top management exercise all substantial authority, there is usually a review committee for all new or increased credits above a modest size. This may be a credit policy committee, an executive committee of the board, or sometimes the full board. Some major banks have both a detailed management review and a review by the board or executive committee.

There is no clear pattern of use of a credit committee or of individuals by different types of banks with two tentative exceptions. First, many independent banks, particularly partnerships or those still thinking like partnerships, tend to have credit committees, since each partner is personally liable for the losses arising from bad decisions. Perhaps a credit committee particularly suits a smaller bank (or one with a small international operation) where the level of expertise may be less widely diffused, and the controls less complex. Above all it is still possible for a few people taking the main decisions to maintain close involvement and detailed knowledge of all of them. The concentration of all lending authority in the chief executive of some small consortia or subsidiaries is perhaps just an extreme example of this. On the other hand a consortium with many shareholding banks may need a committee to prevent any one shareholder dominating the process. Alternatively, shareholders who have specialised knowledge may have to approve any credit in their field or country.

The other tentative pattern was for banks with large, well established international branch networks to avoid senior credit committees. It seems likely that the sheer volume and diversity of decisions would overwhelm a committee in such banks, which are therefore compelled to spread the authority among those most concerned, and perhaps to devolve more. This argument does not seem to apply to domestic networks, however. The big German banks (under pressure of legal requirements) and at least some of the UK clearers have domestic committees as do some French and American banks.

National differences on devolution of lending authority have narrowed since the first edition of this book. American banks still devolve the most; some delegate power to commit the bank to its legal maximum to larger overseas branches. However, the legal limit is so large for major banks that some are beginning to restrict its use in various ways. Perhaps the corporate office must approve the first time exposure goes above a certain level and then further increments of, say, $50 million; or the Chairman of the Credit Policy Committee may need to authorise a special limit for selected names; until he has done so nobody else may approve transactions for that name above a lower limit. Both types of restriction only bite at levels of several hundred million dollars.

Even those Americans which do not devolve the legal limit usually give higher limits than most other banks. The gap between the British and most other nationalities, which was apparent in the first edition, seems to have closed as many banks have increased the amount they devolve. However, European banks seem more divided on whether to devolve within an office to individuals or to limit authority to a branch committee or General Manager; American banks nearly all devolve at least some authority to individuals, even if often on a two- or three-signature basis.

A few banks still devolve little or no authority to branches. This can make for a cumbersome approval process, which must be a competitive disadvantage. However, at least one bank claims that the requirements are so well understood and so much based on mutual confidence that Head Office requires a strong reason to say 'No'; it contrasts this with the situation in some American banks where once approval is required it must cover more than just the broad outline of the deal. The argument thus is that outline approval plus greater autonomy to negotiate the details works just as well as greater authority on amount, but much greater scrutiny of detail on the larger amounts. In brief, one needs to look at the whole culture of a bank before drawing conclusions as to the impact of any one aspect of its requirements. Where the culture is national rather than specific to one bank this may be hard for other nationals to take on board.

For most banks exact levels of authority are confidential, but orders of magnitude can be estimated. The American legal limit, where given, ranges from $100 million to $400 or $500 million, though at the top end the restraints already mentioned may apply.Only the largest branches or regional headquarters have this authority. Among the other American banks, a large branch of a major bank would probably have authority in the $10-50 million range. Smaller banks might grant authority probably in the $2-5 million range. Where the authority is large, anything the branch could not handle would probably go straight to the highest level of authority in head office. Smaller branches may do the same or report to a regional headquarters.

British and European banks seem to give their larger overseas branches or regional headquarters amounts in the $5–$10 million range. However, the limits are expressed in their own currencies; exchange rates fluctuate so that it is hard to generalise about the relationship between different countries. Within head office there is a greater divergence; some banks seem to have several layers of authority with only a few, large facilities needing the highest, while others may go to the board or top credit committee at as little as $15 or $20 million. Domestically, the British banks delegate only fairly modest amounts to regional headquarters. Other European banks vary, at least partly depending on the nature of their board structure. An executive board is more likely to have members with regional responsibilities; then the regional board member may take most of the decisions from his region. With a non-executive board there is less likely to be any regional split; rather all requests above the branch limit will come into the same credit department, credit committee or other processing unit.

In almost all cases, limits reflect the aggregate exposure to the borrower or group rather than the particular transaction. There are some variations around this central point. One bank permits middle/ senior managers to authorise modest transactions for major clients without going to the credit committee provided they increase total exposure by less than 10 per cent. Another has variable limits, depending on the net worth of a company or size of a country. A third allows executives higher limits when approving business for which they are not personally responsible.

A few banks require higher authority to turn down a request than to approve it; American banks tend to take the opposite attitude. No bank appears to have only credit specialists at the very highest level; some use one or more at various intermediate levels, in a large branch, regional headquarters or domestically. In large banks this specialist authority, up to tens of millions of dollars equivalent, may in practice cover the bulk of decisions, leaving the top level relatively few specific decisions and more time for policy and pricing.

The high devolution by American banks dates back less than twenty years.

Until the rapid expansion of the euromarkets and international business generally, a few million dollars would have been the maximum limit for most American banks, and limits of $500,000 or less were common. Some small banks opened branches with low limits, but soon found it made sense to give more authority to people on the spot, once they had proved themselves; a few have even changed their domestic methods as a result of international experience.The same process has affected other banks in the last five or ten years, and may be continuing; the gap may thus close further, although it seems likely that the Americans will devolve authority more than other banks for the foreseeable future.

The question of who has the power to delegate also varies. Some banks require the board or chief executive to approve all individual limits. Others delegate authority to a branch or other unit and then allow the unit to delegate further as it sees fit. Others require top level approval for the highest limits but allow the branch or unit to allocate their lower levels. Where the unit is a regional headquarters this may mean that different regions in the same bank have different levels of delegation and even different rules of exercising authority.

THE ANALYSIS AND PRESENTATION OF A PROPOSAL

The method of analysing and presenting a credit proposal also depends partly on the way in which marketing is organised.

For banks with account executives there are two methods at opposite extremes, which most banks in practice combine but with differing emphasis. At one extreme the banker is expected to analyse the company himself, obtain whatever supplementary information he requires on the company, and the industry, economic background, etc. and make appropriate recommendations. This is likely to be most effective where he is an industry specialist.

The other extreme is to treat the account executive as entirely a marketer and to have a specialist analyse the proposal, recommend whether to lend and if so on what terms. In this form the account executive need have little or no understanding of credit because his job is simply to sell.

In practice, almost no bank admits to complete separation of marketing from credit, although some separate the decision making from marketing, and many worry as to whether their merchant banking arms are not allowing the emphasis on selling new, non-loan products to blind the bank to credit consideration. The difference for banks using account executives is therefore one of degree, with perhaps three variations in common use. First, a specialist department analyses all companies to which the bank lends, but addresses the analysis to the account executive who uses it as part of his presentation. In this case, the best results are probably obtained if the analysis is consciously critical, looking for weak spots, since if it cannot find them the chances of a sound credit are improved. If it identifies problems, the banker must put the problems in perspective, obtain additional information before presenting his case, suggest ways of lending which will reduce the risk or decide not to lend.

It is then clear that analysis is a staff function, a tool for those who prepare the proposal and take the final decision. Trust and communication between the analysts and the bankers are essential. They need not always agree but the bankers must trust the objectivity of the analysts, and the analysts must be confident of receiving honest information and that the analysis will be used for its intended purpose and not as a weapon in intracompany politics.

An intermediate approach is to have the credit analyst work with the banker, providing statistical and technical support and perhaps industry information and some analytical skills. However, the whole presentation including the analysis remains the banker's primary responsibility, and the analyst is clearly in a subordinate position and unable to exercise much influence on the decision.

The third approach is to have the credit department provide a purely statistical support, while the banker does everything else. This may be modified by having the credit department do reviews on request or after the event. The problem is that in this (and to a lesser extent the intermediate approach) the department's work does not attract enough people of high calibre. The availability of an independent review then depends on a limited number of trouble shooters or perhaps on a separate department whose prime function does not relate to credit. In neither case is it possible to be sure of an adequate response to problems. Some banks use graduate trainees, who will in due course be account executives, for this work. Whether they are in a separate department or working as the junior on accounts, this should ensure that the work is done by high calibre people with a genuine interest. It is also excellent training. The only drawback is that these analysts are not very experienced. The advantages of the first approach are greater objectivity combined with consistency of method and quality, while professional analysts work faster, and have a more comprehensive knowledge of the background. The bankers then constantly face critical reviews and must maintain their own understanding of analysis, but are free to spend maximum time and effort on their customers' demands. Without this support, the demands of one customer might preclude their taking the time for a thorough analysis of another. Moreover, the discussion with senior lenders for decision in major cases ensures balance between critical and marketing factors. In brief, the analysts enhance the effectiveness of the banker and improve credit control.

Others feel that a banker cannot exercise full responsibility for his accounts unless he at least chooses how and by whom they are analysed and/or that to understand the borrower the banker must actually do most of the analysis himself; if he does not, they fear he may become a pure marketer. Some senior lenders also object to formal analysis on grounds of length; this seems rather lazy and in any case a good summary and conclusion can often pinpoint the main items to be considered. A more respectable, though still contentious argument is based on cost effectiveness. On the one hand, the cost of even one bad debt saved will pay the salary of many analysts; on the other, it is rarely possible to prove that the analyst saved the loss, while it is always clear what he costs.

There is no one correct answer. Independent analysis will fail if the bankers resent or resist it, if the analysts and bankers do not communicate, if the analysts' independence is undermined or if they become either too remote from commercial realities or too powerful in the final decision. However, it is at least arguable that these factors could be decisive only in conditions which would make the bankers' own objectivity and/or skills suspect, and too much reliance on them dangerous.

Nevertheless, while a significant minority insist on independent analysis, most banks seem to put the main burden on the banker. Even those with strong analytical departments tend to use them more on request or for review. It is difficult to generalise since banks often use similar descriptions for dissimilar functions and do not necessarily use the same method in each branch. This partly reflects local conditions, the availability of information and structure of the banking system, partly the view of individuals within a branch. A successful department, perhaps established on the initiative of a particular manager, may develop an impetus of its own. Conversely, if it does not already exist it is difficult to establish quickly and an unsuccessful attempt may put management off the idea. Moreover, smaller branches may be unable to attract good analysts or justify the cost; to provide a full service from a central point or cover several countries from one branch requires careful control. The methods and functions of analysis thus have little uniformity even among banks with a common marketing philosophy. Indeed, they can vary over time in the same bank. Some banks which used to have an independent analytical department have abolished it; others are moving towards it for the first time.

Departmental marketing means there is no one with overall responsibility for the credit. In some banks the originating department is responsible for the initial analysis and presentation – which may, however, go through several layers before it reaches the decision maker. Sometimes the presentation will have been reworked several times. (In American banks, by contrast, there is usually a conscious effort to keep the layers of review to a minimum.) In other banks the proposal may be handed straight to an analytical department which will review and recommend. In at least some British banks this is the 'advances department' and the advances manager may have substantial lending authority. (No American banks give lending authority to credit departments.) Some British banks have a marketing and credit manager in each department working together to find and justify the business.

One risk of departmental marketing is that different departments may disagree on the strength of the customer, and/or fail to inform each other of warning signs. A lesser risk is of costly duplication. These are partly overcome if decision making is centralised or where there is some form of overall review of the borrower (see below). Some banks, too, while leaving the actual presentation to the originating department, require the analytical department to provide a statistical framework for each analysis. But often there is no overall review of the borrower's financial condition but rather a separate review of the details of each transaction. This impression, gained in the interviews for the first edition, did not come through quite so strongly in those for the second; nevertheless, it is clear that some banks analyse the nature of their borrower, and in particular the sources of repayment, much more closely than others.

In American banks the banker most closely involved with the account is responsible for the presentation, and wherever possible makes it in person. Some European banks seem to prefer to separate the original from the final presentation. The initial analysis will thus be presented to a manager or director; if he decides to take it higher he will do so alone. This was justified by one banker on the grounds that 'if I cannot present it adequately, then I do not understand it well enough to recommend it'. This ignores the possibility that the man on the spot, even if junior, might make a useful contribution or learn from the discussion; American banks place a considerable importance on both aspects.

Where there are several branches dealing with the same borrower and offering facilities in several countries, banks need procedures for allocating responsibility as well as limits. This is obviously less complicated for banks which devolve very little authority, but even they have to decide who is responsible for the initial recommendation and subsequent monitoring. The problem is partly one of the legal entity which is borrowing and partly one of country limits and responsibility for countries and areas.

If an American bank's Belgian branch is asked to lend to a Belgian subsidiary of a major US company, does the branch make the initial decision in all cases, in some, or in none? There are two common answers. One is that the local branch looks at the credit of the local company. If it is acceptable in its own right and the amount is within the branch's limit, the branch must inform head office but can approve the proposal on its own (although there is an explicit or implicit right of veto from head office if the parent is unacceptable). If the local credit is not acceptable, the branch must ask head office whether the parent support is available and acceptable. Head office then decides the precise form of support required, although the branch's views of the subsidiary may influence this decision. The process is more complicated if in the example given the parent is French and the amount outside Paris Office's limit, but the same principles apply.

However, some banks require the banker responsible for the parent relationship to assess its overseas subsidiaries even where there is no support, in the light of the overall relationship and credit standing of the group. Some do this only in cases where the parent is followed by a 'multinational' division.

A problem in all lending across borders is ensuring compliance with domestic regulations, exchange control and banking practice in a country with which the lending officer is not familiar. Most banks require any loan to be approved by the local branch on these points and for availability of funds, whoever approves the credit. This is simple enough when the lending branch originates the loan, but it is often overlooked when the negotiations take place elsewhere. It is easy to arrange in New York for a Latin American customer to borrow from the London branch secured by a matching deposit; but the security may be invalid if registration at Companies House is required and not undertaken in time. Effective controls are necessary to avoid this type of trap as well as ensuring most favourable tax treatment.

In brief, presentation and analysis in branch banking seems to have little uniformity or standard methods. Each bank has a different approach, with branch procedures not necessarily even deriving directly from those in head office.

Banks must ensure that the borrower's accounting is fully understood and that the analysis is in a form comprehensible to the decision taker and which allows fair comparison with other countries. Having a branch in the country concerned should ensure knowledge of local practices, but a small or newly established branch may not have the volume of business to justify sophisticated analysis. And it is hard to be sure that they can explain the local requirements to head office clearly and meet the requirements for information there. To the extent that it is possible to lend secured, this may be less important, but where unsecured lending is required it is crucial.

Even without a branch in a country a bank may do substantial business with companies there. A good example is Scandinavia; British banks with a long Scandinavian connection and American banks with a more recent but growing one, make substantial loans in eurocurrencies from London or New York, in addition to normal trade financing, It is possible for both bankers and analysts to understand Scandinavian accounting and banking practices from London. It may require analysts to travel to each of the Scandinavian countries to discuss accounting, tax, and banking and business practices with local businessmen. It is sometimes important to know, for instance, why Swedish banks take security for domestic lending, or in which countries the published figures are meaningful, or what adjustments are needed to make them so; whether the banks regularly receive management figures or forecasts so that foreign lenders should expect to receive the same.

However, while fruitful and well worthwhile, this exercise is expensive and the cost must be justified by substantial and profitable business. Conversely banks which are not prepared to make this type of effort to understand a country probably cannot justify the risks involved in a substantial corporate portfolio.

THE MONITORING OF LOANS ON THE BOOKS

It is one thing to make sound loans, quite another to ensure they remain sound over long periods. Methods of doing this are again affected by the internal organisation, but also reflect different ways of combining or separating four aspects of the problem. For discussion these aspects may be classified as:

(a) Common to all facilities, including for example paying out and receiving funds, calculating and collecting interest and fees.

(b) Mechanical items of frequent occurrence, but with greater variation between transactions. These include the documentation and control of collateral, checking papers on documentary credits, exchange control approvals and distribution of information to a syndicate.

(c) Less common items requiring extra knowledge but still relating solely to the particular facility. These include the decision whether to accept valuations or specific items of new collateral, receipt and checking of information for compliance, changes in operation of the facility (and occasionally in its nature, amount or maturity) which require a new credit judgement. If things start to go wrong they raise questions requiring high levels of judgement and knowledge about the borrower as a whole, not just the particular loan.

(d) The more general aspects of the overall relationship with the borrower, his initial credit standing and any changes in it. It includes specific items relating to any individual facility, but the implications are assessed in the light of the borrower's overall standing, not just the one facility.

It is difficult to generalise as to how these functions are combined. One difference is clear, however. Most American banks distinguish between 'operations' and 'banking'. Everything discussed in (a) and (b) above, and perhaps some items in (c) are regarded as operations and are handled by operating departments. The bulk of (c) and (d) is handled by the banking division, including the analytical (or credit) department. The credit department may be responsible for establishing a tickler file for receipt of figures, certificates of compliance, etc. and may also spread (set out on a special comparative form) the figures when received and check compliance. In some banks the credit department will also review the figures of all borrowers annually (or more often if appropriate), and will be on the lookout for any adverse information about the company.

Other American banks rely on the banker for this review, in which case the credit department may be available on request or when a problem has been identified or confined to the more mechanical aspects of follow up. However, more banks seem to require a regular annual review by the credit department than require a full analysis in the first place. All agree that whatever the support given, the banker is primarily responsible for monitoring the credit and alerting senior management to problems as early as possible. The credit department is always a staff department however much its importance varies.

This distinction between operations and banking probably arises naturally out of the marketing methods. An account executive has a broader brief, and is more a part of management, than if he is responsible for only one aspect of the relationship; at the same time it is impossible for him to be intimately involved in the day to day workings of all departments. A need therefore develops for people with the specific skills and temperament to handle all the detailed transactions and controls arising out of the business, and at higher levels to pull all the various operations together. One effect of the trend towards securitisation and emphasis on marketing is to make credit look more like a part of operations, handled separately by specialists, and less like an integral part of a banker's skills. This trend is certainly not yet fully established and probably never will be. However, there is a dawning realisation in some banks that some changes in approach are needed to deal with the changing relationship between marketing and credit; particularly as the new products are bringing new risks which nobody yet fully understands.

The distinction also fits well with the concept of lending to a going concern. A bank which relies on the continuing ability of its customers to generate cash flow, rather than on assets or security, must have someone taking a view of the whole borrower, but at the same time each facility must be properly handled.

American bankers mostly believe that this distinction - apart from being vital to their particular way of doing business - is desirable in itself and allows a valuable degree of specialisation. However, the separation has disadvantages, mainly of difficulty of communication. The two divisions may think differently, operate under different constraints, use words to mean different things. This is less important in domestic markets where growth is relatively slow, few changes are made in types of facility and there is a high proportion of experienced staff in both divisions. In international markets, and those domestic markets which have been opened to international competition, however, recent growth has been rapid, many new facilities are being introduced and a high proportion of the staff of both divisions are either inexperienced or their experience relates to a different environment. Here communication is a real problem.

British and European banks mostly do not make this sharp distinction between operations and banking. There the lending is on a departmental basis, all aspects of the facility may be handled within the department concerned. Or there may be an 'advances department' (British), a 'loan secretariat' (French or Belgian) or some similar department, which combines some of the functions of a loan department and a credit department in an American bank. Even those banks which have country desks, and something approaching an account executive there, concentrate much of the operational work within the desk. The advantages are much closer interlinking between all the aspects of a particular facility.

In all banks, each facility is reviewed at least annually. Interviews for the first edition gave the strong impression that many non-American banks mainly monitored the mechanical details of the facility, rather than the overall condition of the borrower; interviews for the second suggest that more attention is now paid to the borrower's financial condition. However, the extent of the change is not entirely clear. As far as events of default are concerned, while a missed payment or inadequate collateral is taken seriously, a default in financial covenants or a decline in overall financial condition is not. Even where ratios or interim figures are required, some banks seem to pay little attention to them.

These remarks may be somewhat sweeeping, and reflect the cumulative impression of a number of interviews rather than specific comments from any one bank. The difference between the American and the European attitudes and the problems of terminology are such that it is impossible to be sure that comparisons are accurate, and there are of course variations between banks of the same nationality. But the general impression remains that European and Japanese banks – and, to a slightly lesser extent only, British banks – put their main effort into following the facility rather than the borrower. They really start to look closely at the borrower only when he is visibly in trouble - by which time it may be too late.

MONITORING THE QUALITY OF THE PORTFOLIO, PROCEDURES AND STANDARDS

Apart from specific loans, the overall quality of the portfolio, of the decisions and of the way in which they are carried out must be monitored. The elaboration with which this is done depends on the size of the bank and the number of countries in which it has branches as well as the variations in marketing and devolution of authority.

It may be necessary to monitor the concentration of the portfolio, geographically, by industry or other type; to control maturity and mismatch, which have some implications for the bank's treasury but are also important credit factors; and to assess the average quality of borrower or loan. But most important is a continuing review of the people and the standards they apply in making and controlling loans.

A small private bank with no overseas branches and all decisions made by a credit committee consisting of the bank's senior management is in a sense checking the quality of the people every time it looks at a loan request. Also, it is essential but relatively simple for such a committee to develop a real knowledge of people, the procedures and individual loans in the normal course of business with few if any formal procedures.

It becomes more difficult with branch networks and devolved lending authority. All banks rely on external auditors, and US banks often on bank examiners, as an independent check and some put their main reliance on these outside reviews. Internally there are three possible methods of monitoring the portfolio, and it is quite common to combine any two or more.

The first method involves continuing quality controls within each branch, and at head office. In small branches these operate very much as in a small bank, but subject to head office review. Even in larger branches, a continuous review may be made by the general management of the branch, either in the form of the credit committee making all major decisions and reviewing all major facilities annually, or by some continuing review by branch management of decisions taken with devolved authority. Either as part of this, or in lieu of it, there may be a specialist staff officer or group who surveys and reports on the quality of the lending, the quality of individual loans, the use by lending officers of their authority and the effective cooperation between the various departments. In any except the largest branches, this function may be combined with others and the 'Credit Officer' may be a specialist lender or administrator as well. However, whether as a specialist within the management or as a separate (almost auditing) staff officer he will do most of the detailed work, identify and follow problem loans, supervise and assist weaker lending officers, ensure adequate communication between various sections of the bank. There will be some provision for him to report to or coordinate with a similar function in head office as well as the management of the branch (whose performance he will in a sense be reviewing) but the form of this varies widely. As an integral part of the branch, such a Credit Officer is well placed to review and to influence the quality of lending provided he does not lose his independence.

The second method is to have a 'loan audit' department, reporting to the senior management of the bank, directly or via the controller or accountant. It may have offshoots in the larger branches or regional headquarters. It performs a continuing audit of loans, collateral, procedures and systems. This is primarily an American concept. The audit may include a full analysis of some of the borrowers but more often reviews the quality of the analysis done before loans were made and pays considerable attention to the mechanical aspects.

The third method – inspection – has some similarities with loan audit, but a longer history. A team, usually of line bankers seconded for a two-to-three year period, inspects all branches and head office divisions periodically. Each inspection is a surprise examination with no set interval or warning. Most banks have a maximum eighteen months or two years between inspections of any unit, but more frequent inspections are common, sometimes in inverse relationship to the quality of the unit being inspected.

Most inspections, particularly where lending authority is not devolved, may not look at specific decisions or examine the borrowers in any detail. More often, they examine the documentation of loans, the systems controlling the follow-up of payments or collateral, as well as many areas not related to lending at all. They appear more interested in compliance with the conditions on which the loan was made than whether the conditions were right initially, or whether subsequent changes have made them out of date. Inspection is widely used by British, continental European and Japanese banks, and its form seems to confirm the earlier comments that most of these banks are more interested in monitoring the transaction than the borrower.

The advent of the computer has opened up new methods of monitoring which only a few banks yet seem to be using in any depth; even those that are would probably not claim to be meeting the optimum standards yet.

Where banks use ratings and store them in the computer these can give profiles both of the total portfolio and of segments of it. Equally, the portfolio can be broken down by industry; if this shows a heavy concentration in one industry the bank can quickly see whether the ratings applied to that industry give cause for concern. It can then either focus on particular names or alter its lending policies to reduce the concentration with whatever degree of urgency seems appropriate. In due course, it ought to be possible to store details of vulnerability to specific events. Then if, say, the price of a particular commodity or exchange rate moves sharply and unexpectedly, a bank could call up a full list of all names which might be hurt by the change and the bank's exposure to each. This is already done by a number of banks for country exposure but the idea does not seem to have spread to other types of classification. Similarly, few banks yet use comparative profiles of ratings to see how the quality of the portfolio is changing over time or with changes in economic conditions. Even fewer use the computer for any sort of screening, but at least one applies a series of tests based on financial ratios to all its borrowers, and takes a closer look at any which fail the tests. Inevitably, if this test is to catch most loans where there is a real deterioration, it will catch some where there is not. But the need to treat the results with care does not detract from the chance to pick out names which may have slipped through other forms of monitoring.

COUNTRY LIMITS

Reservations expressed by a few banks about the need for country limits in every case have largely disappeared since the first edition. All banks now either set specific limits or rank countries in from three to five grades. Most which grade countries do so as an aid to setting and monitoring a limit, rather than in lieu of it.

The top grade, or sometimes two, will cover countries of a size, variety of exposure, political stability and economic strength which leaves no reasonable possibility that the banks could lose everything. Here there may be either no limit, or a purely nominal one, substantially above any expected exposure. One (or occasionally two) further grades may cover countries considered sound but more at risk, and finally there is a grade for unacceptable countries. There will usually be a limit on the intermediate grades – either an absolute figure, or occasionally a percentage of actual or planned volume of loans. The limit on the uncreditworthy grades will be nil unless the country was previously considered creditworthy, in which case it will be set to prevent new exposure.

Among larger banks with sizeable branch networks there seems to be a fairly standard approach to setting country limits. The credit committee (or occasionally a subcommittee) sets the limit usually subject to ratification by the chief executive or the board. Where there is no credit committee there is often a special committee which typically consists of the senior executive in the international division, the heads of the various geographical areas and the senior credit specialist. In a few cases limits are set by an individual, probably the senior credit officer, international, who will consult more or less formally with the head of the international division.

There are normally three areas of the bank involved. The initial recommendation comes either from the local branch, from the regional headquarters or from the country desk in head office - i.e., from the people who are on the spot, understand local business and politics and the opportunities for profitable business within a given limit. There is usually also a comment from a credit specialist; he may be in head office or the field, and his comment may be included in the main presentation or it may be separate Most major banks also use economists, although some are sceptical of their value. For smaller countries their analysis may be limited to a financial and statistical summary; for larger ones a full economic review will probably be discussed with the other two groups so that all three can present a coherent and consistent recommendation, or the grounds for disagreement can be clearly established.

The larger banks mostly review limits annually or semi-annually, although a few do it on a rolling or Forth Bridge basis; the number of countries and people involved makes more frequent discussion of all of them impractical. However, there is always a provision for an emergency review if an increase is needed or if problems arise. Most banks normally relate the limit to the maximum they expect to want to lend rather than the maximum they would ever be prepared to lend.

In the smaller banks, the procedure is less elaborate but otherwise similar. Because they have fewer branches and divisions, there will be less people involved. Not all smaller banks have international economists and some rely on outside economic reports. Where there is a large exposure, one or two senior people not directly responsible may make a point of visiting the country to get an independent feel of the situation.

Smaller banks review country limits more frequently (even if perhaps less intensively) than larger banks. A number conduct a full review quarterly, few do it less frequently than semi-annually.

Banks consider not only individual country limits but also exposure to regions and types of country. Exposure to many countries in a particular region - even though each country has different problems, resources, political systems, etc. - can compound the exposures to regional catastrophe. Events in Portuguese Africa and Rhodesia in the 1970s caused trouble to many countries around them, as did the Vietnamese war to many in Indo-China. The Mexican moratorium of 1982 had a ripple effect on almost the whole of the rest of Latin America, which is still continuing. Exposure to countries in widely different parts of the world can also be linked if they are all heavily dependent on the same commodity; banks should be aware of their indirect exposure to the cycle of demand and supply for copper or lead, coffee or sugar.

Finally, banks normally review and restrict their total exposure to lesser developed countries as a whole and particularly to the poorer groups. Whether a bank develops its own rating systems, or whether it uses the World Bank's categories, ranging from the lesser developed oil producing countries through various levels of per capita income, it needs to be sure that its loans are not concentrated in the weaker countries.

7 Loan Documentation

This chapter deals with the documentation of medium term agreements. Short term facilities, while they must be legally enforceable, do not require full documentation in view of their demand nature. Documentation of an agreement is not an isolated exercise, but an intergral part of the negotiation of the substance of a loan, and an essential record of what has been agreed. No agreement can turn a bad loan into a good one, or create assets which do not exist. And while an agreement must stand up in court, a main objective is to avoid ever having to go to court, since the obligation to pay will be clear.

MAIN FUNCTIONS OF THE LOAN AGREEMENT

Identification and Definition

An agreement identifies the various parties to the loan, their rights and obligations, and the remedies if either is unable to perform. It also includes a description of how the facility is to be operated. Individual clauses will be discussed later in the chapter, but the main areas which a loan agreement must cover must first be understood.

The parties to the agreement and their respective postions (lender, borrower, agent, guarantor) within it must be described; so must the amount to be lent, the maturity, rate of interest and repayment requirements. NIF/MOF agreements must also cover the mechanisms for auction (TP, agent, etc.), the existence and membership of the underwriting group, and TP(if there is one), the other types of facility available in a MOF, and the conditions in which the borrower can use the underwritten facility.

The conditions precedent (which must be met before the first borrowing) and continuing conditions (which the borrower must meet throughout the life of the loan) also need careful definition. The continuing conditions are particularly important in NIF/MOF and facilities intended for horizontal sale; in a crisis, they will decide who is obliged to accept the risk.

Conditions precedent include proof of the borrower's authority to borrow and of the specific authorisation of individuals to sign and operate the agreement; compliance with statutory or regulatory requirements and receipt of necessary permissions; a corporate borrower normally also represents and warrants that he is not in breach of any other agreement, his articles or by-laws or any government regulation; that the financial information he has given is accurate and that there has been no material adverse change since it was prepared, and that there is no threat of material legal action. These representations establish the factual basis on which the bank agrees to lend. They may become part of continuing conditions by being repeated at each new draw-down or rollover, or at other agreed intervals, although if they are too sweeping unwanted events of default may be created. If the facility is secured or guaranteed or allocated for a specific purpose, or has various other special features, these may need to be covered as part of conditions precedent and/or continuing conditions.

Continuing conditions include payment of principal and interest when due, compliance with covenants (including maintenance of collateral margins where appropriate), maintenance of sound financial condition and continuing compliance with other loan agreements and contracts.

The agreement defines the circumstances in which the borrower may repay early or the bank may demand repayment prematurely. This may be due to conditions beyond the bank's control which make it unable to continue to lend, or it may have the right to call the loan if the borrower fails to make a payment when due or to comply with one or more covenants, or breaches a continuing representation and warranty, becomes insolvent, or enters one of the various preliminary stages of insolvency or is in default in any other way. By giving a right to accelerate before the borrower has failed to pay, some of these act as an early warning system and ensure the ability to negotiate before outright insolvency. Here again, in NIF/MOF and loan sale agreements, these clauses will largely decide how the risk is divided; they may not always make this clear and may differ little from traditional wording, but their precise form will be examined at length in any dispute about who is responsible.

Method of Operation

The agreement describes the method of operating the loan so that both sides can make it work for its whole life. It must describe clearly the timing, calculation and method of payment of interest, principal and fees; disbursement of the original loan; valuation and insurance of collateral; rights to call for additional collateral or for the borrower to have collateral released; the calculation of additional interest during a default, as well as the requirements before claiming repayment if there is an event of default; the correct method of applying both mandatory and voluntary prepayments, and any special requirements. The need for clarity is even greater in a syndicated loan; the agent must account to the syndicate for any error and justify any change in the agreement, but a sole lender can more easily adjust operational weakness after the agreement is signed, with the borrower's cooperation. (Not that a bank should ever rely on the borrower's goodwill, but the penalties for sloppy drafting are greater in a syndicated loan.) In addition, the rights and obligations of the agent must be clearly spelled out (see Chapter 5); this can be done in a separate agency letter but this is now rare.

Too many bankers and lawyers forget this prime operating characteristic of every agreement; perhaps American banks are the worst offenders, due to the separation between operations and banking. The agreement has important legal implications and must be legally watertight, but the number of agreements which come to court is small. All agreements have to be properly operated, and over-concentration on legal purity, if it interferes with operating practicality, is dangerous. (The agent risks finding himself liable for the whole of the syndicate's loss, not just his own share, if he makes operating errors.) It takes an experienced banker to get the balance right between operating complexity which causes him to be nickel and dimed to death with extra costs and errors, and over simplification which can cost a large sum in the rare cases when the agreement is tested by a liquidator.

THE DEVELOPMENT OF LOAN AGREEMENTS

Before the 1960s, most medium to longer term international lending was done by institutions other than banks. Some medium term bank lending was done from New York and the documentation followed New York practice and law. Since the development of the euromarket, an identifiable euromarket approach to loan agreements has developed. Some fairly standard clauses now define common features of an agreement. Some of these remain valid even for new types of transaction, others are having to be modified or completely replaced; some are combining banking practice with capital markets practice. Nevertheless, there is a bedrock of standard practice on which lawyers draw, even for completely new products.

One common element is that agreements are mostly drawn under either English or New York law. Other laws are acceptable and may occasionally even be preferable, but banks will require a good reason to depart from the laws they know best, and to which market practice is most clearly related.

The history of the eurocurrency agreement parallels that of the market described in Chapter 1. Since initially eurodollar lending was mainly short term, the documentation could not be described as a loan agreement at all. When medium term lending began it was mostly by single lenders and to the strongest US or European companies; although the first agreements were slightly more elaborate than for short term lending, they were usually simple and drafted by bankers. Probably the first move towards greater formality came from banks who were worried about the imposition by one or more governments of reserve requirements or other restrictions. Their protective clause, initially quite short, grew gradually more complex and wider in coverage, so that now it runs to several pages in many agreements. At least part of the greater length was required to meet borrowers' demands.

As syndicated lending developed and smaller companies began to borrow, documentation became tighter, lengthier and more complicated. In particular syndicated lending, with its requirements to define the agent's role, focussed attention on weaknesses in earlier agreements and banks became less willing to rely on their own drafting and more dependent on outside lawyers (although even now some banks draft their own agreements when they are sole lenders). For smaller (although mostly still fairly substantial) borrowers covenants and restrictive clauses and tighter default and cross-default clauses all became more common. The fact that syndicates included banks not close to the borrower and therefore unwilling to take much on trust hastened this process, which also partly reflected the lender's greater bargaining power in 1974–6. The prolonged period of intense competition and easy money following 1976 unfortunately undid most of the good work.

As countries began to borrow, directly or through state entities or nationalised industries, new factors had to covered, notably sovereign immunity. More sophisticated facilities also tended to have longer agreements. The concept of multi-currency lending (enabling the borrower to switch from currency to currency within one facility) is fairly simple. To describe it clearly so that both parties always understand it, so that it relates back accurately to the original currency and so that commitment fees can be accurately calculated regardless of exchange fluctuations, takes several pages. Even an optional interest period requires precise definition, particularly if varying sized tranches have to be matched against fixed amortisation.

THE PROBLEM OF LENGTH

Loan agreements have consequently been steadily getting longer and more complex, requiring more specialised skills to interpret (although agreements drafted by European lawyers are normally still shorter than domestic US agreements). Many bankers feel agreements drafted by US lawyers for the euromarkets are too long, sometimes out of touch with market practice and less clearly drafted. There is growing resistance from customers and bankers to this length and obscurity and even lawyers point out, rather plaintively, that they are not paid by the page.

Some Reasons

Some increase in length was inevitable in view of the growing complexity of the substance of the agreements and experience of the weaknesses of shorter agreements. There were five main factors pushing in this direction. The first was the reluctance of borrowers to accept clauses protecting the banks without qualifications and exclusions. This may have reflected misunderstanding of the real purpose of the clause or fear that the bank would use it unreasonably. Borrowers are fully entitled to guard against unreasonable interpretations, but should first be sure they understand the clause; if they still need qualifications, the extra length is then in their interest.

The second factor was the extent of unused flexibility which was being built into eurocurrency agreements. Apart from multi-currency clauses and variable interest periods discussed above, examples included facilities revolving for a period, then convertible into a term loan; variable amortisation patterns; recapture of earnings clauses; prepayment rights; rights to fix the rate for the remaining life; rights to borrow via various subsidiaries from different branches of a bank. All of these and others are valuable in appropriate conditions. Not all of them are useful in every case, but they are frequently offered as if they were, and the price is inevitably a long agreement.

The third factor was the natural tendency of lawyers to try to protect their clients against every conceivable risk, however far fetched. (Bankers, too, may be reluctant to eliminate a clause which they have become used to seeing in agreements, even though its purpose may be accomplished by other means.) There was an increasing tendency (see Chapter 5) to put in protective clauses even where they probably would not work, just in case they might. This natural tendency was reinforced by cases where the precise wording of what were regarded as minor clauses had a major (although sometimes almost accidental) impact on banks' ability to recover their loans.

The fourth factor, in many people's view, was the way in which banks (and particularly American banks) were hagridden by their lawyers. Many corporate executives continue to believe banks permit lawyers to dictate not only the form of the agreement but even much of the commercial substance. European bankers are inclined to believe this of at least some American banks, and a few American banks even believe it of their compatriots. Whether this view is justified or not, it is strongly held by enough people to need to be taken seriously.

The fifth factor was the much faster turnover of bankers than lawyers. As a result, experienced lawyers often dealt with less experienced bankers. Since a good lawyer develops commercial and market experience, the temptation to offer these is natural, even desirable. An experienced banker will take the responsibility for shortening agreements where appropriate. Less experienced bankers may be overawed by the lawyer's greater expertise, and/or believe that the lawyer gives, rather than takes, instructions. Thus what should be a constructive partnership can deteriorate into a senior/junior relationship.

American Background

In considering the relationship between American banks and lawyers it may be helpful to look at their domestic background. American banks are more regulated and restricted than probably any other banking system. There are 50 state banking laws, a Federal banking law, detailed regulation and examination, and numerous other laws with applications for bankers, such as anti trust and securities laws. Many laws carry criminal liability, and directors may be held personally liable for the acts of their subordinates, while even a prison sentence is possible. However unlikely this may be in practice, no bank is going to accept the risk lightly; if a legal opinion protects against criminal liability, the bank will accept the restrictions that opinion may impose. Combined with the notoriously litigious nature of American business, it is not surprising that lawyers are more important and agreements more detailed than in Europe.

There is no doubt that even in the United States agreements could be shortened if there were sufficient pressure to do so, nor that lawyers play a more important role in the negotiation of US domestic loan agreements than in any domestic European market. This increases the risk of lawyers becoming so dominant that they take commercial as well as legal decisions and even negotiate with the borrower. Lawyers agree that their function is to advise on the legal implications and to analyse the issues at stake but let the banker make the commercial decisions; most will, however, acknowledge the temptation to cross the line. But it is the bank's relationship with the borrower, and the bank's money, which are at risk, and the banker must judge those risks; nobody else can properly do it.

Banker and Customer Contribute

It is particularly up to the bank to decide on the substance of the covenants; the lawyer's job is to make them work. It is thoroughly undesirable when more dominant lawyers try to negotiate on these and other commercial points and it is a weak banker who permits it.

Bankers cannot afford either to give away completely on every point, or to be so rigidly insistent that they lose business. If they are to strike the right balance they must not only understand what makes a good loan agreement, but be able to explain it. Customers in turn need to distinguish essential items (efforts to eliminate which simply raise questions about their understanding or good faith); items which, individually, are desirable rather than essential but which as a group are necessary, so that while any one can be negotiated away, an attempt to eliminate all of them is counter-productive; items which are primarily there for the customer's benefit so that the bank will not care if they go; and items which the bank likes to have, but which are of minor importance, possibly there only as a bargaining makeweight. Because every customer has a different set of circumstances - and whims - the first draft often includes more of the second and fourth categories than are absolutely necessary. The bank knows the customer will reject some, and will certainly refuse to allow new clauses to be inserted during negotiations. If the bank chooses only those which the customer rejects, it will be left with an inadequate agreement.

A customer who knows his business and negotiates intelligently should have no trouble in obtaining a workable agreement. If he blindly digs in his heels and insists on a short agreement regardless of content, he may find that the parts most helpful to him are eliminated, including the very element of medium term commitment which was his prime requirement.

To do his part, the banker must have a sound knowledge of the legal framework as well as of banking requirements. If he does not fully understand the legal implications he is unlikely to make a good commercial judgement. In turn a lawyer who is not sure his customer has understood the legal points will be tempted to overemphasise them. However, the growing complexity and cost of all eurocurrency agreements despite the efforts of bankers and the heated opposition of borrowers supports the view that the problem is not just a result of domineering American lawyers, and that the reasons already discussed, and perhaps others, provide a genuine justification for longer agreements.

In short, the relationship between banker and lawyer is crucial. Each must understand what the other is trying to do. Since the banker is ultimately in charge, he must be able to explain clearly what he wants and why, the competitive constraints of each position, and any particular sensitivities in relation to each borrower. Equally, however, the lawyer must be alert to take account of these points without allowing his client to take risks of which he is not aware.

Much the same is true of the relationship between the borrower and his lawyer. If they are to work effectively to shorten loan agreements, their attack on length must be selective, and pay heed to the bank's genuine needs. Otherwise, they may weaken agreements so much that, when the dangers of that weakness become apparent, banks overreact and borrowers end up with even longer agreements.

Presentation, as well as substance, is important. Agreements should be structured so that related points are grouped together and easy to find, and have a close correspondence to the way in which the market works. Even such simple points as having an index of clauses, and making sure that the definitions at the beginning are short and clear, and do not include detail which belongs in the body of the agreement, or vice versa, can make a surprising difference to the ease with which an agreement is operated.

SOME SPECIFIC CLAUSES

Changes In Circumstances

The clause which started life as the reserve requirement clause is now more generally known as 'Changes in Circumstances'. It normally consists of two main sections (although it may be combined with the second and third clauses below in one clause with four sections). The first provides that if any law or regulation of any country with jurisdiction changes in a way which makes the loan illegal, the borrower and lender must try to find a way of continuing the loan that is legal – perhaps by moving it to the lender's office in another country. Failing agreement, the borrower must repay. The clause allows for payments in syndicated loans only to those banks which are affected by the change.

This part of the clause is now standard market practice, although sovereign borrowers still occasionally resist it. The wording usually tries to protect the bank against being forbidden to lend, while the borrower is allowed to borrow; it also tries to give as much flexibility as possible to avoid a loan being illegal where it has this type of clause, while it would not be without it. Banks cannot risk being required by some law (or, worse still, 'voluntary' regulation) to recover their loan, but having no contractual power to do so; this despite the lack of any case history of such legal changes, or expectation of them.

The second part of this clause is known as the 'increased cost clause'. Briefly, it protects against a change in reserve requirements or taxes (other than income tax) or any other aspect which increases the cost to the bank of maintaining or funding the loan. The borrower, once he is told of this change, can either absorb the additional cost or repay the whole of the loan unless, again, the cost can be avoided by moving the loan. This clause took a long time to become accepted by borrowers and some of them still dislike it, but it is now standard in the eurocurrency market. In practice no reserve requirements have ever been imposed on eurocurrency loans, but they have been on domestic sterling deposits. (The clause was very seldom implemented even then, because it was not worth annoying the customer for the additional income involved. However, a specific formula has now been introduced which compensates the banks automatically for the extra but variable cost.) Although the clause has hardly been used, banks agree that they cannot risk any erosion of the narrow margin on which they lend. At one stage banks occasionally accepted a slightly higher margin to waive the clause. This proved too expensive a compromise and borrowers no longer ask for it.

The Eurodollar Disaster Clause

This and the next clause date from about the time of the Herstatt crisis in 1974. Where there is no London interbank rate quoted, then the bank and borrower must negotiate a mutually acceptable alternative within thirty days. If they fail, the borrower must repay. So far the clause merely recognises conditions under which the normal rate setting mechanism would be inoperative. In practice, few banks believe this is a real possibility, although the prospect of freak conditions pushing the rate to unacceptable levels is a different matter. There is also a possibility that certain types or nationalities of banks might be excluded from the market, and in syndicated loans the possibility that some banks only might be unable to obtain a quote is allowed for.

It is arguable that this clause eliminates part of the bank's commitment, certainly to a specific margin and possibly even to lend at all, just when the borrower most needs the money. However, once the loan is made, the same conditions which prevent banks obtaining dollars will also affect borrowers. A strong borrower might be able to convert his own currency into dollars to repay, but there can be no certainty on this point, particularly in countries with tight exchange control.

Unrepresentative Cost

If the interbank rate, while still quoted, ceases to represent satisfactorily the cost of money to some banks in the syndicate, this clause entitles them either to establish a new rate mechanism or again be repaid.

This clause mainly helps weaker banks and may seem unfair to borrowers. The use of a representative group of reference banks theoretically incorporates an allowance for any general premium paid by weaker banks. In practice, a syndicate with one small reference bank out of four might well quote a rate that was profitable to the big banks, but not to small banks. The question is whether this gives a sufficient reason for the small banks to evade their commitment, since the risk was foreseen when they decided to participate.

Small banks would presumably argue that because it was foreseen, they would not commit without the protection of the clause. The original theory of both clauses allowed banks to obtain relief only for general factors affecting a clear sector of the market, not to compensate for individual failures; it is not clear how well current market practice maintains this theory.

Borrowers should thus give careful consideration to this point in syndicates where there is a high proportion of small banks, or banks from weak countries, or countries where central direction may push all banks in the same direction and weaken their ability to fund. They should also recognise that the price of borrowing medium term money at short term rates is some weakening in the banks' commitment, in a way which may seem onesided, as compared to a fixed rate loan. This is particularly true in market conditions which erode banks' profits margins on syndicated lending as happened in the early 1980s.

Sovereign Immunity

Sovereign immunity is important in lending to governments and some government agencies. Under most laws - but to varying degrees - a sovereign state has traditionally been immune from suit or seizure of assets, outside its own borders and sometimes within them. In 1976 and 1978, respectively, New York and England passed acts which narrowed the range of sovereign immunity, and made it much less of a problem in loan agreements. Where other laws are used, banks must check the treatment in each case; the older, more sweeping sovereign immunities can leave banks at a considerable disadvantage.

Governing Law and Jurisdiction

Clauses with related implications are the governing law and jurisdiction clauses. The former specifies by which law the contract shall be governed. The considerations as to which law should apply are those of having an established body of commercial law and precedents; a competent, highly qualified, honest and numerous legal profession; and finally a court system which is relatively predictable, impartial, free from political or chauvinistic bias, and with a constitutional tradition barring retrospective legislation.

While only one law can apply to an agreement, jurisdiction to hear any case can be taken by courts in several countries. It may be desirable in particular circumstances that a case under New York law should be heard in an English court, or vice versa. Procedural rules in one country may allow a favourable interpretation of another country's laws which would not be possible under the different procedures of the home country.

These are sensitive areas for LDCs and their governments. The inference may be drawn that some of the requirements in the first paragraphs are lacking in the country whose law is rejected. While this is often true, it is not surprising that it is resented. The problem is that countries where the criticism is most valid are often also the most indignant. Even where this is not so, a concession to one country makes it much harder to refuse elsewhere. In particular, the possibility that government (possibly after a revolution) will compel its courts to rule in its favour is even worse than the risk of it ignoring an adverse verdict. A banker with a favourable decision from a court of high standing has a continuing pressure point on the borrower (the 'right to harass'); rejection of the judgement undermines the borrower's credit standing. An adverse verdict in the local court under local law, however obviously biased, leaves the bank very little leverage. Even if its own government is sympathetic, the possibilities of diplomatic pressure are reduced; and the prospect, even ignoring sovereign immunity, of seizing (or at least blocking) overseas assets disappears.

Some banks are more tolerant about conceding sole jurisdiction to the country of the borrower – on the grounds that, since it is virtually impossible to enforce a claim on a reluctant government, nothing is gained by upsetting it about a minor point. There are three answers. First, banks should have access to independent legal mechanisms to judge, if not enforce, their claim and maintain the right to harass; secondly, the weaker the banks' position the less they can afford to have it further undermined, and thirdly, if a borrower intends to meet his obligations he has nothing to lose by submitting to an impartial court; while refusal to do so raises questions as to his good faith. (A borrower must recognise and accept the meaning of all clauses in the agreement but perhaps particularly this one. Easy acquiescence may mean that when the implications subsequently dawn, the customer will be very much upset or in a few cases that he does not mind what he signs because he has no intention of being bound.)

Cross Default

This important clause reached its full importance in the euromarkets in the mid-1970s, although it had long been common in US agreements. In its simplest form it provides that a default by the borrower (or, where appropriate, guarantor, subsidiary or other defined party) under any other loan agreement constitutes an automatic default under the bank's agreement. There are, however, some subtle variations in wording. The clause may cover an event which, with the passage of time, will create a default if not corrected; or more commonly the cross default may operate only after the grace period has expired without correction; it may cover defaults even where the prime lender waives them, or be applied only where the prime lender declares a formal default.

The clause saves banks from standing helplessly by while other loans are being compulsorily paid ahead of them, to their detriment, or a rescue deal is negotiated over their heads. Complications may arise because borrowers are reluctant to allow a cross default where the cause is out of their control and does not necessarily reflect on their creditworthiness - e.g. - withdrawal of a specific exchange control approval. Banks argue that prepayment for these reasons can still undermine a credit, but they may be more willing to concede where they are protected by strong covennants or a continuing material adverse change clause. Careful drafting is required if the clause is to meet the interests of both parties.

The argument in favour of triggering a cross default clause as early as possible is that the borrower has the power to avoid any default (with the exception mentioned.) Once he has (even potentially) defaulted, his credit is suspect and the bank should not have to rely on another lender's credit judgment. Moreover, the default may give early warning of a position more serious than is immediately apparent and allow the bank to review its situation and perhaps get out just in time. The converse argument is that, until action is taken, the danger of one lender obtaining a preferred position is not significant. Where the default is a technical one only, the clause could give a bank an unfair opportunity to pull out for other reasons although its loan was not in real danger. Moreover, it is at least odd that an agreement should give rights to banks not party to it even before those who are parties to it choose to exercise those rights. A situation could exist where a bank with a well written agreement in technical default was working with the borrower to improve its loan, and suddenly found the company liquidated by another bank with a much weaker agreement, but a strong cross default clause. Finally, some banks consider medium term loans virtually as demand loans because the cross default means they can be called whenever an overdraft is called – a point borrowers do not always seem to appreciate and which might change their view as to the value of the commitment in a short agreement.

Whatever the rights and wrongs cross defaults are standard practice; a strong lender will usually insist that they apply at least where there is a right to call a default, although not always during any grace period. Borrowers should therefore be sure they understand the implications of the precise clause used in their agreements. Borrowers under NIF/MOF or horizontal sale programmes should assess the impact of a cross default on the responsibilities of the various banks most carefully.

Material Adverse Change

In its most sweeping form, any material adverse change in the standing or affairs of the borrower becomes an event of default. In more limited forms, the change is confined to specific types of change. The clause often gives the lender the ability to judge what is material and to call a loan without establishing a specific default.

Most American banks feel the clause has continuing value only in the absence of adequate financial covenants, which they prefer for a number of reasons. (See below under 'Financial covenants and ratios'.) This value is further reduced unless the clause clearly specifies that it is in the bank's sole discretion to decide whether any adverse change is material. Even then the bank may be reluctant to demand repayment, because the default is a matter of opinion not fact, and the last thing it wants is a long drawn out lawsuit. However, where the clause applies only to the period between signature and actual borrowing, it has real value, particularly if defined fairly narrowly. The borrower must then sue to obtain the loan, rather than the lender sue to obtain repayment so that all the delay and doubt are in the bank's favour. Nevertheless, even in this situation the clause still risks the borrower being surprised and resentful, and no bank likes being sued even if it wins. A reputation for using the clause arbitrarily could be very damaging to a bank's business.

American banks are surprised how many European borrowers prefer a continuing material adverse change clause to specific covenants. Covenants are discussed below, but it is difficult to see how a borrower, who needs the certainty that funds will be available, can accept a clause which makes the commitment subject to the bank's judgment. While banks are unlikely to be deliberately unreasonable, there is room for genuine difference of opinion as to what is material. Since most borrowers take a sanguine view of their own financial situation, when the bank is less sanguine it can come as a nasty shock, even if the bank has tried to communicate its doubts. Of course, a borrower may even expect the bank to waive breaches of specific covenants, but at least he is likely to test the ground. Even the most sanguine borrower should take note of a refusal, or even reluctance, to grant the waiver.

While these comments remain valid for conventional loans, the advent of NIF/MOF and horizontal loan sales reopens some aspects of the argument. The underwriter/seller will often have an undrawn commitment, even when the borrower is using the facility. Thus a material adverse change clause may seem more attractive. On the other hand, the noteholder, as well as the borrower, now has an interest in restricting the scope of the clause, and may become unwilling to buy paper subject to such a clause.

Notes

Under US law notes (ranging from simple promissory notes to promises to pay backed up by a page or more of closely printed conditions) are normal and have some advantages, as they do under some other laws. However, under English and most European laws they are not necessary and can have certain, admittedly minor, legal disadvantages and occasionally attract stamp or other tax as well. Most European borrowers and banks dislike and resist notes. Many US lawyers, and US bankers who have not worked overseas, refuse to take this resistance seriously and try to insist on notes whether or not there is any value to them. They overlook the fact that in the eurodollar market operating personnel are not used to notes. The cost of imposing unfamiliar operational requirements may often be errors far more costly to the banks, and particularly to the agent, than the probable benefit of notes in all except a few countries. Where notes really have a significant benefit it is certainly right that they should be used, although multiple notes, which sometimes even the lawyers get wrong, must be carefully explained to ensure correct handling. Where there is no specific benefit from notes, it is undesirable to impose them and complicates the agent's task unnecessarily. Also, the cost in annoyance to the customer can be substantial.

Again, NIF/MOF and loan sales may change this attitude somewhat; notes are certainly the most convenient (although not the only) way of transferring title. The eurocommercial paper market operates on notes.

Financial Covenants and Ratios

The purpose of financial covenants and particularly of ratios is easily misunderstood by borrowers and commentators. It is threefold:

(a) to establish agreed criteria as to what constitutes a substantial change in the borrower's condition, not initially foreseen by either side, and therefore a legitimate matter of concern.
(b) In case of such a change to give the bank the opportunity to discuss the implications for the bank's loan, and if appropriate amend the agreement to take account of it or
(c) If the bank is not satisfied with the discussion and any following action, to give the right to demand repayment if, in the bank's judgement, this is necessary to protect its loan.

The financial ratios should thus be set in agreement with the borrower, after analysis of forecasts as well as historical information, with both sides agreeing what the company expects to do, and why, and what degree of deterioration is more than a normal fluctuation.

Banks need the ability to monitor a medium term commitment, because borrowers inevitably change over five, seven or ten years. Unless the bank can review these changes, the risk is greatly increased and may make the loan unsound. At the same time, the borrower needs to know what the bank expects from it and why, what the bank will view as a significant deterioration and what with more equanimity. The purpose of these clauses is thus not to enable the bank to control the borrower or with very limited exceptions to veto (still less impose) managerial decisions. Certainly, the right of veto arises where a change threatens to weaken the bank's position, but covenants are intended more to give the bank the right to discuss than to veto.

Negative Pledge

Some covenants, apart from financial ratios, are common in the eurocurrency market, others mainly in domestic American bank loans. The most important standard clause is the 'negative pledge' or 'pari passu' clause. In its simplest form, this forbids any secured borrowing unless the bank is secured 'equally and rateably' or 'pari passu'.

This prevents the bank's position from deteriorating in relation to other lenders. Unsecured lending will not work if assets and earnings arising from them are applied preferentially to other claims. Moreover, although few banks expect repayment from liquidation of assets, they certainly take that possibility into consideration, so that a situation where most or all of the assets are pledged to other lenders is not tolerable. Thus, the negative pledge is a vital part of any unsecured medium term loan, although it can be qualified in various ways. It can, for instance, exclude secured lending already existing; this does not involve a change in condition from the time of the agreement. It can permit a specific amount or type of secured borrowing. Where an overall amount is permitted, it may be either a single figure or a percentage of net worth; where specific types are allowed, there will also usually be a maximum amount. This clause can become quite complicated in companies with numerous subsidiaries, or in lending to governments where the central bank or state trading companies hold assets or cash flow which must be covered by the agreement. A variation of this clause is a prohibition on upstream guarantees unless the bank gets identical guarantees. (Downstream guarantees are usually permitted since the debt will be reflected in consolidated figures and caught by other ratios; sometimes they can be dangerous, however, and should perhaps be more carefully controlled than they are.) Care should be taken, in drafting negative pledges, to avoid covering routine events and causing a stream of unwanted defaults and waivers.

Some clauses restrict the sale of assets or of a major portion of the business, and sometimes of subsidiaries above a certain size. These are most imortant (and likely to be most tightly drawn) with weaker borrowers. Again, the purpose is to prevent radical changes in the nature of the business which might undermine the bank's position.

A restriction on the payment of dividends is also quite common in the United States, but resisted quite strongly elsewhere by stronger borrowers. This prevents the company dissipating its cash flow and weakening its ability to pay its debts.

A more specialised clause, but very useful in the right circumstances, is the recapture clause. Under it all or part of any increase in earnings above a certain level must be used to prepay the loan. This can apply to the general cash flow, or to a specific stream of cash such as charter hire. On a project loan or one to a country dependent on one product for export earnings, it may even be linked to the market price of the end product rather than specifically to profits. Since it allows the bank to benefit from unexpectedly favourable events, it is most appropriate in fluctuating or cyclical situations, where an upturn may well be temporary. The recapture ensures that the benefits of the upturn are used at least partly to protect against the adverse effects of a subsequent downturn.

A fuller discussion of all of these clauses can be found in *The Medium Term Loan Markets* by J. A. Donaldson and T. H. Donaldson (see Bibliography).

8 International Insolvency

Although the principles of dealing with failing companies are the same everywhere (and are covered more fully in *How to Handle Problem Loans*), there are extra complexities where the lenders and borrower, or the borrower's assets are in different countries. The determination of which insolvency law applies or which court has jurisdiction may affect recovery of debt substantially.

At least however by that time the problem is a recognisable one which clearly involves the lawyers. Other dangers, due to unfamiliarity with local law, lack of a local branch or of appropriate experience, may arise before insolvency is certain or even before it is recognised as a serious threat.

This chapter highlights some facets of how banks can handle international insolvency. The final legal details cannot reasonably be foreseen by the banker either when he makes the loan or when he first begins to realise that it is doubtful. But law and practice in most countries are such that, in the period leading up to insolvency, specific actions or omissions can substantially affect the bank's position. Knowledge of bankruptcy and pre-bankruptcy procedure in each country enables the bank to take advantage of these points. However, it is important to keep up to date; recent legislation, not yet fully implemented in Britain, and proposed in France, would change creditors' positions in major ways.

This chapter will also discuss dealing with an insolvency from a distance; the need to ensure that the maximum recovery is made from both borrower and guarantor; the additional currency risk and some risks which, while they can arise in any insolvency, cause additional complications in international insolvency. Finally, while countries cannot be liquidated, this chapter discusses government defaults.

JURISDICTION

The question of which insolvency laws apply does not arise often; when it does it is usually important. It can arise where a group has subsidiaries in several countries, which are insolvent as a result the parent's insolvency. There may then be a series of liquidations - or, in countries such as France where an auction must be held within a fixed period - it may be vital to keep the subsidiary out of liquidation until assets can be realised on favourable terms. Inter-company payments valid under one law may be challenged under another, with the result affecting the percentage payout by each company. Upstream or blanket guarantees can complicate the matter further, particularly if there is any doubt of the power of the subsidiary to give such guarantees, or of the benefit obtained by it.

A branch is part of the same legal entity and the liquidator controls its liquidation under parent country laws. But if preferential creditors rank differently in the two countries, which law covers the creditors of the branch?

Assets can move across borders at key moments. At the time of Penn Central's bankruptcy some of its rolling stock was physically in Canada; it was not clear whether the US bankruptcy court could protect it from seizure by Canadian creditors without a separate order from a Canadian court.

Parent gurantees can also raise difficult questions. For instance, an English property company went into liquidation. Its French subsidiaries, borrowing under the parent guarantee but also secured by real estate assets in France, were liquidated more than a year later. It took over five years for the liquidator and the French lenders to agree a basis on which they could seek a court ruling on when interest ceased to accrue: from the date of the parent's liquidation or that of the French subsidiaries? The difference was several million French francs, and a sizeable transfer between creditors.

The 'lex situs' applies the law of the country in which security is located to the realisation of the security. However, it cannot override all aspects of the law of the agreement or of the country of the borrower. Thus if a charge on the assets of an English company is not registered within twenty-one days of being created, English courts will refuse to enforce it. Even if it is validly registered, however, or does not require registration because the company is foreign, the borrower must still have power to give the security and the wording of the agreement must coincide with English rules on security as well. Liquidators will therefore scrutinise all relevant laws carefully - which is one reason why lawyers fuss about apparently minor details in loan agreements. The risk is not merely of a conflict, but of failure to meet all requirements through ignorance.

DIFFERENCE AND SIMILARITIES IN BANKRUPTCY LAWS

There are some common features in the insolvency laws of most Western countries, but the technical details and framework of interpretation vary significantly, and each country seems to have its own quirks which may throw foreign creditors into confusion. How many foreign bankers in London, for instance, understand the Rule in Clayton's Case and the implications for overdrafts? How many English bankers know whether there is any similar feature in the various countries in which they do business? (The Rule in Clayton's case, in summary, says that in the absence of specific allocation, payments into an account shall extinguish the oldest items first. The effect is that continued activity in an account may cause the overdraft to be considered as new borrowing, even though the amount owing remains stable. The results can be good or bad for the bank, depending on the precise circumstances.)

No one chapter can review the whole of bankruptcy law in even a few countries. This section merely tries to alert banks to the nature of the differences.

Many insolvency laws have most of the following points in common: a date at which the bankruptcy is deemed to have started; one or more prior periods during which actions taken by the bankrupt and by creditors are particularly subject to challenge; restrictions on the validity of security taken either within a set period, or when the borrower was known to be insolvent; a system for ranking different types of creditors, including forms of security; some right of set-off; provision for uncompleted contracts; rules for guarantees; registration of a claim for voting purposes; and often a creditors' committee to review the action of the liquidator. But this list tells little about insolvency law in any particular country, and despite the superficial similarity, actual practice and the attitude of courts to creditors is very different from country to country.

The date of bankruptcy is usually decided by a court, but on varying criteria. There are several types of corporate insolvency in England where the liquidation dates from presentation of a petition to the courts. However, the petition may not be heard for several weeks and could then be rejected. There is thus a period during which nobody knows whether or not the company is already in liquidation. (For this chapter, 'liquidation' will be used to describe the formal bankruptcy or winding up of a company under court supervision, regardless of where it happens.)

In France 'cessation de paiement' is the time at which the company is held to have become incapable of making payments as they fell due; this again is before the date of judgement. In Germany a court resolution follows an investigation to establish that the debtor is indeed insolvent. Other laws have similar provisions. From the date, however set, the borrower is protected from creditors and no longer has power to dispose of his assets or make contracts. Understanding the events which can start a liquidation prior to a formal ruling are thus crucial in working with a borderline company.

In addition to protection in liquidation, most laws provide for scrutiny of all actions for an earlier period, to prevent some creditors receiving favourable treatment at the expense of others. In English law 'fraudulent preference' has no criminal connotations, and where there is pressure from the creditor payment is seen as an attempt by management to prevent liquidation, rather than as a voluntary preference. In other countries such pressure might itself be grounds for reversing the payment. While the concept of 'relating back' is valid in some form for most countries, the period it covers varies quite widely and may depend on the type of transaction or of creditor involved.

Management of an insolvent company which continues to trade and accept new credit may be personally or even criminally liable. In England 'fradulent trading' can carry criminal liability in some cases although ignorance of the insolvency may be a defence for non-executive directors. The new offence of 'wrongful trading' contained in the present Act will make it harder for a director to plead ignorance. Directors may be personally liable in a number of countries, and in France can be made personally bankrupt.

The definition of when a company is insolvent and the directors are at risk is often fairly vague and may depend on factors such as the willingness of banks and/or creditors to continue to make credit available. Directors often need specialist advice before continuing to trade, and in some countries the rules make it difficult to keep a management team together to save a borderline company.

Most bankruptcy laws have tight restrictions on the ability to give security in the run-up to insolvency. Under some laws security given for new advances will usually be allowed; a surplus on realisation of this security may even, in some circumstances, be available to meet other debt. In other countries, however, the question of benefit or reasonableness is ignored, and any giving of security in this period will be cancelled. Indeed the acceptance or rejection of a defence of 'reasonableness' and its definition are important differences between national insolvency laws. While legal advice can be taken once the position is recognised, the greatest danger arises where the bank fails to realise that it is in a danger area and subject to abnormal risks.

All countries give some creditors a preferential position, sometimes even ahead of some types of security, sometimes applied only to proceeds of specific assets. Some countries have degrees of priority within the preferential creditors, others treat them all equally. All countries have provision for security which allows priority over unsecured creditors, but the forms of security, rules for ranking them and requirements for registration are all different. Some countries treat all unsecured creditors equally, others allow for ranking among unsecured creditors. The importance of subordinated debt in the United States is one example of this; the need to register debt and its ranking by date of registration in Spain, another.

A common list of preferential items would include income, property and social security taxes, wages (and taxes witheld from them) and other quasi-public charges. However, most countries will have some special additions, and each country will have different rules as to the amount and/or period covered by each type of preference.

Subrogation can also affect priorities. In England, for instance, bank loans to pay wages have the same preferential rights (with the same limitations) as the wages themselves and anybody who pays a debt on behalf of another benefits from any rights of recovery the original creditor had. Other countries have less well-developed rules of subrogation. The subrogation rights of guarantors or subordinated lenders can have a serious impact on all creditors (including the beneficiary of the guarantee where he has other debt) and need to be carefully considered in each case.

In looking at security the bank must be sure not only that its claim is valid, but also that it does not step into the liabilities of ownership – to pay property taxes, for instance. Exchange control approval may be needed before the proceeds of collateral can be transferred overseas. The attitude of local courts to the respective rights of debtor and creditor, and to specific actions such as foreclosure, may be as important as the letter of the law. The right to manage or sell the security and any risks in doing so (such as the costs incurred by someone who arrests a ship) must be known as well as the best methods. The impact of items such as reservation of title must be understood. Certainly the impact of the Romalpa Case in the UK has caused many UK banks to take a second look at their floating charges. (Romalpa established for the first time that reservation of title clauses, common in some European countries, can be effective in English law.) The clause prevents title passing to the buyer until all debts to the seller are paid, and means that the buyer in turn cannot give a valid charge on the assets since he does not legally own them. The new Act codifies and confirms the effectiveness of reservation of title. Trade creditors, on the other side of the fence, are looking at their terms of sale.

Most countries allow at least some right to set off debts owed between the same parties against each other. The items to which this right applies, and the conditions under which it can be exercised, however, are not uniform. In England set off is fairly narrowly defined but where it exists the bank is required to exercise it in liquidation. In the United States its application appears to be much wider; American bankers as a result tend to assume a right of set off in other countries when it does not exist. In France the right of set off is admitted at liquidation if the asset and liability clearly arise out of the same transaction, but is not allowed in other cases or subsequent to liquidation. The provisions in various countries for bankers' liens also have something in common with set off, although strictly set off applies to money debts only.

Most countries permit the liquidator to adopt or repudiate contracts with outside parties. If he adopts them he must perform and the other party may be a preferential creditor for amounts arising during the liquidation, although the ranking of amounts owing prior to liquidation will not change. If he repudiates them, most countries allow a claim for damages for any resulting loss, which ranks as unsecured. The calculation of damages on, say, a ship charter or a forward exchange or commodity contract is not clear. There is an obligation on the creditor to minimise the damages, but it may be a difficult decision as to whether this is best done by covering in the market now, or waiting for an improvement and risking even larger losses. It may not be possible to quantify the actual damages for some years, which can delay final payment to all creditors.

However, Norway for one does not allow damages; the Norwegian liquidator can repudiate an uncompleted contract and accept a claim only for money due prior to the liquidation. This can have a significant bearing on the decision as to when to force liquidation.

REORGANISATION AND INSOLVENCY

Many countries have provision for an attempt to reorganise a failing company under some form of protection from its creditors, and allow it to be restored to financial health. Such an arrangement may be considered pre insolvency or may be covered by insolvency law; many countries have both.

England was unusual in having no general provision for such a reorganisation. A receiver often carries out much the same function and has full powers to manage the company, but can be appointed only by a debenture holder secured by a floating charge. The new Act, however, allows the appointment of an administrator who will have similar powers to a receiver, but will represent all creditors; his appointment will not depend on there being a floating charge.

In the United States Chapter XI of the (Federal) Bankruptcy Reform Act provides for a court supervised attempt at reorganisation, and most major insolvencies go through before liquidation. There are also informal 'composition' arrangements possible in various states, but these do not carry court protection. In France the 'suspension provisoire' is a pre insolvency procedure which allows the debtor to operate for a maximum of three years under court supervision to implement an approved programme likely to benefit creditors. There is also the 'réglement judicairé' formal insolvency procedure which still provides for continued operation of the business in hope of full recovery. Belgian, German, Italian and Dutch law, among others, all have some provision for reorganisation, and usually more than one gradation. Many laws allow for some form of composition with creditors, which may be binding on all if a qualified majority (usually 75 per cent or more) votes for it, or if the court so orders. Some require that the debtor demonstrate that a minimum percentage payout will be achieved, and require security to be provided for that amount. A few even allow security interests to be overridden; although this seems to be rare in a formal sense, US courts can and do delay the exercise of their rights by secured creditors for lengthy periods during which the value of the security can decline substantially. The Penn Central was a prime example; for years after it entered reorganisation, no secured creditor was allowed to realise any security. Much of it was rolling stock which deteriorated due to lack of maintenance. The British Act and French proposals already mentioned threaten the validity of security in certain circumstances, as do laws of other countries.

Since these procedures can seriously affect the repayment of a loan, bankers need to know what type of a scheme is possible, how it works and in what way they can influence the decision. They may need to coordinate with other major creditors. They also need to ensure that their default clauses give them the maximum rights to override such schemes.

Apart from reorganisation or composition there are differences in the whole framework of insolvency. Countries seem to fall into two main groups. These are those where an individual (who will be referred to throughout this chapter as a liquidator although he will have different names in different countries) responsible for realising the assets and validating and paying claims is appointed by creditors; in a reorganisation he may run the company, often with assistance from its previous management, to whom he may return control if the reorganisation is successful. In a full insolvency he may operate all or part of the company for any period necessary to improve the return to the creditors. Although ultimately answerable to a court, operating within legal rules and often supervised by a creditors' committee, such a liquidator has considerable discretion to make commercial judgements.

Direct appointment of the liquidator by the court, which closely supervises his actions, is more frequent and means that decisions are likely to be more legalistic and the whole procedure less flexible. In some cases liquidation is so cumbersome and expensive or the rules so rigid that creditors will make every effort to avoid it. They may try to carry out an informal liquidation of their own, despite the risks if they fail.

Even where creditors (or occasionally shareholders) elect a liquidator, he is usually subject to court approval and may be bonded. Nevertheless, there is likely to be a professional body which makes its living working for creditors and has a commercial interest in being seen to do so effectively and at a reasonable cost. It is not intended to suggest that court appointed liquidators are less professional or personally less concerned with the creditors' interests, but the lack of commercial pressure and the much closer court supervision probably make it harder for them to act decisively, or take commercial initiatives. In England, and most countries which follow English law in this respect, the receiver or liquidator is usually an accountant; in most European countries he is a lawyer; in the US it is common to appoint a successful, perhaps recently retired, businessman, at least in cases of reorganisation of major companies in Chapter XI of the Federal Act.

An international banker needs to know, for each country, how a liquidator is appointed, under what rules he operates and the quality and nature of the insolvency profession. Where creditors appoint the liquidator the bank needs to understand the method of appointment, to have several competent appointees in mind, and to be able to assess appointees suggested by other creditors. Commercial pressures work both ways, after all, and even the strongest profession has its fringe operators.

Finally, most laws provide that the liquidator, whoever appoints him, should be assisted or supervised by a committee elected by creditors, usually subject to court approval. Sometimes the committee merely advises the liquidator on commercial matters, sometimes it reviews and approves major decisions. In Norway at least it is the main decision maker, with the liquidator acting purely as an administrator. Members may also have technical duties, such as counter-signing cheques drawn on the liquidation account. Again, it is important for a bank to understand in advance the workings of this committee, whether it is desirable to be represented on it and if so how to use the representation to best effect. It is likely, however, that members will be required to act in a personal capacity on behalf of all creditors, rather than specifically representing their employers.

HANDLING AN INTERNATIONAL OR MULTINATIONAL INSOLVENCY

Any insolvency which involves a group of affiliated companies is liable to be complicated by inter-company transactions. Checking that they are legitimate and tracing claims through the subsidiaries is complex and can have a major impact on the relative benefits to different creditors. While some laws allow for a pooling of assets and liabilities (in England a 'scheme of arrangement') this is unlikely to be practical if any creditors feel unfairly treated. It may be necessary to pay off small creditors in full, or on favourable terms, before such a scheme can be implemented. Some countries, notably France, allow the corporate veil to be pierced in these situations.

Subsidiaries in a number of countries compound the difficulties. Tracing and recovering payments from a British subsidiary to a finance vehicle in Luxembourg and from there to Hong Kong, Australia and New Zealand can be very difficult, even in the absence of fraud; given fraud it is probably impossible and the chances of recovering anything traced are smaller still. Prevention is therefore better than cure; once insolvency is even remotely possible, the bank needs to have a clear view of the room for damaging inter-company transfers, and to take steps to prevent them. Otherwise, at best the sheer delays in the liquidation are very costly, as each liquidator strives to establish the true assets in a web of inter-company transactions; at worst the recovery can be reduced to virtually nothing.

Lenders covered by a parent guarantee have a claim in the liquidation of both borrower and guarantor. (Of course, it is perfectly possible for one or more subsidiaries of an insolvent parent to be sound; lenders to the parent, however, may only be able to benefit to the extent of dividends or proceeds of sale of the shares.) For maximum advantage the bank needs to preserve the assets of all entities before liquidation. This is not always straightforward. For instance, looking at the subsidiary alone the bank might feel the best prospect for recovery came from an early liquidation, but this might undermine efforts to keep the parent alive. Conversely, in keeping the parent alive the bank may allow it to siphon resources out of the subsidiary but still fail to bridge the parent's deficit and thus lose all benefit of the resources.

Deciding where the bank's interest lies depends on a complex of factors, including the amounts each entity owes, and its relative solvency. For example, if a bank's sole debt is $5,000,000 from a subsidiary, guaranteed by the parent, almost certainly it is right to conserve the subsidiary's resources. The increased dividend it obtains will be greater than any improvement in the guarantor's dividend resulting from upstream payments. However, if the subsidiary owes $500,000 but the parent owes $10 million separately then the benefits of keeping the parent alive, if there is any real prospect of doing so, may be substantial. The relative benefits will still be affected by the bank's share of the total debt of both parent and subsidiary, as well as the importance of secured or preferential creditors.

To justify keeping the company alive, the bank must be able to see some prospect of improving its position and also believe that any additional loss if the rescue fails is fully justified by the chances of recovery. If either the parent or the subsidiary can continue to pay interest or make a modest reduction in principal or even convert some unsecured into secured debt on a basis which a liquidator will allow, all this helps justify postponing liquidation. The lack of any immediate improvement makes the longer term risk harder to accept.

The more the bank can recover from the subsidiary, the less its loss if the parent cannot meet the guarantee in full. Furthermore, the less the size of the subsidiary's claim under the guarantee, the greater the payout to the parent's direct creditors. And if the subsidiary can be sold as a going concern or can generate surplus cash which can be passed to the parent without undermining its ability to meet its own debts, then there is a real incentive to keep both alive.

However, the bank needs to be extremely careful. It must not damage the interests of other creditors of either parent or subsidiary or lay itself open to challenge by the liquidator of either. In most countries there is a broad range of actions which a bank can take which are considered to be reasonable efforts to protect its assets. However, in each country the line between this and being considered either to manage the company, or unreasonably encourage it to continue trading when insolvent, is a fine one. It is drawn according to different criteria and the bank needs expert advice in each country. Failing that there is a real risk of becoming liable for debts incurred by the company and/or criminally liable, depending on the country concerned.

These considerations apply in all group insolvencies but their complexity is greater in multinational insolvencies. Risks unique to international insolvency are currency risk (see below) and the public relations risks. Visible responsibility by a foreign bank for the liquidation of a company can have political overtones of a type banks particularly dislike, and which threaten the bank's other business in the country. At the same time, the detailed involvement in the subsidiary can be less effective and more dangerous if the bank does not have a local branch with experience of insolvency. Against this, a bank which is not prepared to consider liquidation as an option weakens its bargaining position. If the borrower believes the bank is prepared for liquidation if necessary, it will be much more likely to take painful action. If the action is unsuccessful either the borrower or an outside creditor will probably start the liquidation, allowing the bank to avoid the political odium. On the other hand, if the bank is bluffing, and is called, it probably loses more in the end and may still be forced eventually to petition for liquidation.

One of the hardest points in any threatened insolvency is to persuade management of the seriousness of the threat; too many executives concentrate on keeping customers, suppliers or unions happy at the risk of the company's future existence. This may be particularly true where a parent has not communicated the extent of its own problems to the subsidiary which therefore expects to be supported. (Any suggestion that the parent is too important to its own country to be allowed to collapse compounds this feature.) Finally while, for a major bank, $500,000 or even $5 million may be a relatively small loss, the amount of business required to generate that much profit is substantial. The risk of losing business may also be overestimated by marketing officers, and this is particularly so if it is another branch which suffers the loss.

Currency fluctuations may contribute to the insolvency in ways described in Chapter 3. But actual liquidation introduces new features. Intercompany debt paid during the suspect period may be called back, in which case currency fluctuations could make the cost of repaying greater than the original receipt. Moreover, even when the liquidating dividend is close to 100 per cent, it may not be paid for several years, and at an exchange rate defined differently in each country. French courts, for instance, apply the rate on the date of judgement but allow for payment of any shortfall if all creditors are paid in full. British courts also normally apply the rate on the day of judgement, but in the case of debts due within the Common Market a recent court judgement required payments due in foreign currency to be made in that currency. However, this may not apply outside the Common Market, and is only one of an increasing number of examples where it is necessary to check the existence of any relative EEC directives.

In English agreements a clause requiring the full foreign currency debt to be paid regardless of changes in exchange rates after the day of judgement or liquidation is sometimes used. This has never been tested in the courts and it is by no means certain that it would have the desired effect.

At best, the bank has an uncovered exchange position, for an indefinite period and of an indefinite size. The original loan will usually have been matched by a deposit in the same currency but this ceases to be practicable once there is no expectation that the loan will be paid in full. While the provision made may be adequate for the loss expected at the then exchange rate, the amount recovered in the bank's own currency may be more or less than expected due to exchange fluctuations.

HANDLING INSOLVENCY AND MAKING PROVISIONS

Some conclusions as to the requirements for handling international insolvency, at least for banks with major branch networks, suggest themselves. (Smaller banks can manage less elaborately but the principles apply.) First, a man on the spot is needed to deal closely with the failing company. This usually involves a branch or representative in the country; while in turn a branch makes a spread of corporate business more likely. Some types of insolvency may be manageable from outside a country by people who know it, travel to it frequently and have good contacts with lawyers and accountants. Nevertheless it is usually difficult to give the day to day attention insolvency requires. It follows from this that banks should be more than usually careful about corporate lending in countries where they do not have a local representative. Moreover, a complicated insolvency requires special skills and knowledge, which the manager of a small branch may not have; it also takes more time than a smaller branch may be able to devote. It therefore pays to have a support unit, covering quite a wide area, which can help smaller branches in emergencies.

The second requirement is a coordinating point (in head office or in a regional headquarters) to review the information on all the borrowers and to assess the best reaction in the bank's overall interests. Without such coordination a strong personality may impose the course which suits his particular branch best, without having a full picture of the bank's overall interests. The coordinator may be either a senior banker or a credit specialist, or both.

The third requirement is for a recognised method of handling bad debts within each unit. In their domestic operations, banks broadly fall into three categories. Some have a full time specialist group (called 'the hospital' by a Japanese bank) to take over complete responsibility for insolvent companies when they reach an agreed point. Others take the view that the officers who got the bank into this position should get it out, and that doing so is excellent training. (However, they will be closely supervised.) Many compromise and decide depending on the complexity of each situation and the competence of the officers concerned. Even where a specialist takes over, the account officer may remain involved to provide continuity. In smaller banks any director who happens to be available may be assigned; while not a specialist, he will be expected to have experience of insolvency and be a tough negotiator. Some banks have one unit which handles work out or potential rescue situations, and another which deals solely with companies in liquidation.

Few overseas branches have sufficient business to justify a full time insolvency specialist, but may have a credit specialist with experience of insolvency. For the local aspects of an insolvency they will have some of the limitations of a smaller bank, but with the advantage of being able to call on the experience of their head office.

The methods used to identify and reserve against actual and potential bad debts vary in formality and frequency. Banks usually go through the exercise of examining their bad debts and reviewing their reserves whenever they report to shareholders - quarterly for American banks, semi-annually or annually for most others. The exercise may involve a Charge Off Committee in head office, and possibly in the larger overseas branches, which will collect reports on all identified problem loans, with recommendations as to the size and nature of provision, and perhaps as to whether to continue to accrue interest. Many banks, however, are much less formal with specific provisions made only as each case deteriorates, but still with a periodic review of the overall reserve. The precise stage at which each bank provides for a loss and whether there will be any distinction between a 'charge off' and a 'reserve' will depend partly on tax and regulatory requirements, but will also reflect on the bank's own standards and degree of conservatism.

In addition, most large banks have some form of a 'watch list' for loans identified as risks higher than normal which require increased attention. Some banks then rate problem loans by degrees of risk, others have a section within a broader rating system, others simply have a list on which names can be put to indicate weakness, and the need for special procedures.

INSOLVENT COUNTRIES

Although a country cannot be liquidated it can become unable or unwilling to meet payments of interest and/or principal as they fall due. The number of Imperial Russian and Chinese bonds still quoted on the London Stock Exchange at fractions of face value, although some matured decades ago and no payment has been received in some cases for over fifty years, illustrates this point adequately.

An insolvent country may denounce its debts outright, in which case banks can do very little directly. A defaulter faces the risks discussed in Chapter 3. If none of these risks deterred the country from repudiating its debts, no bank or group of banks is likely to have more influence, at least until the country has actually experienced the reality of the risks. And Cuba has demonstrated that with the right friends a country can survive.

More probably a country will fall behind on its payments and then gradually cease to make them at all, but without any formal repudiation and without initially intending to do so. This is due as much to the inherent bad management as deliberate intent. A similar but less serious situation (which probably reflects better management) is where the country realises that it is running into trouble, and asks for rescheduling of its debts under the threat of inability to pay but without actually ceasing payment.

More common in the 1980s has been a moratorium called by a country to allow it to negotiate a restructuring with the banks, IMF and other lenders. This is most likely where a specific event (sharp rise in interest rates, fall in price of major export) undermines a country's ability to service what was in any case excessive debt.

In all cases, the banks need to meet with the central bank or finance ministry to obtain full information and to negotiate a restructuring of the debt. In the earlier, small restructurings it was sometimes possible to negotiate a package covering the whole of a country's debt; then the aim was to set a level of debt service which the country could meet, but which allowed no latitude for importing luxuries or financing corruption. In later, more urgent and complex cases, banks usually dealt with one year's maturity at a time; however, as it became clear that the problem was much longer term than originally thought, they began to move back towards rescheduling at least several years' debt at a time – the so called 'multi-year rescheduling'. They also had to consider, in each case, whether to agree to new loans; sometimes these were used partly or wholly to service debt. Often they were a genuine increase in exposure, to give time for the (often IMF-imposed) remedial measures to work. The number of banks involved varies from ten to several hundred. To make negotiations manageable there will usually be a committee – of from two or three to perhaps fifteen banks, depending on the size and complexity of the problem. In the very large cases (Mexico, Brazil, Argentina, for instance) there may also be a number of subcommittees, composed of three to five banks, dealing with different aspects; or one or a small group of banks may be assigned to develop and implement proposals for a particular part of a country's debt (interbank, other short term, medium term, public sector and private sector could be examples).

While there is always a risk of different interests or views among the banks complicating a restructuring, that risk is greatest for the larger countries; these tend to have several hundred banks. These range from large money centre/clearing banks to small regional banks, some of whom have lent only in a syndicate and have no loyalty to the borrower, and through all types of nationality and the related tax, regulatory and attitudinal backgrounds. They also exhibit varying degrees of skill, calmness or excitability, willingness or reluctance to cooperate, flexibility or bureaucracy in decision making, and so on. Often the smaller banks are unable to be involved in the hard work of restructuring, but suspicious that the banks who actually do it will favour their own interests. This leaves the large banks a difficult line to tread; if they rely solely on rational persuasion, a few obstructive banks may wreck a whole rescue, while if they try to apply pressure it may prove counter-productive, particularly in raising new money.

Indeed, the question of unanimity in rescheduling grows steadily more difficult. Traditionally (and for sound reasons) all banks lending to a country are treated in the same way (or at least, within types of lending; see *How to Handle Problem Loans*). This becomes harder when new money is in question, and harder still when the problem drags on through a series of of negotiations; banks become more recalcitrant as the initial panic or desire to be more constructive wears off. At the time of writing, the suggestion that some of the smaller banks should drop out of Mexico, Brazil, Argentina, etc. is not being well received. It seems likely to come up again, however.

The larger countries also introduce a complication which barely existed in the smaller, earlier reschedulings, of the private sector. In those earlier reschedulings, almost all loans were to the state or to stage agencies, or with government guarantees; the private sector in countries such as Zaire and Zambia was not strong enough to borrow internationally. But the major Latin American borrowers, and some other troubled countries, have large private sectors, which borrowed freely in international markets. Sometimes, indeed, governments made special arrangements to encourage them to do so, and sell the foreign currency to obtain funds for domestic use. Banks then faced a double risk; first that the economic conditions which made restructuring necessary – or the remedial measures taken in conjunction with restructuring – would bankrupt many private sector companies; and second that even companies solvent in their domestic currency would be unable to buy foreign currency because of their country's problems. Governments, and banks, had thus to ensure that the terms of any restructuring allowed the solvent private sector to service its debt, but without causing a drain on foreign currency which undermined the position of sovereign lenders. Various methods were used – special rates of exchange; or deposits of local currency with the central bank, which then repaid the foreign currency (and interest) over a period comparable to that of its own restructuring, for instance. None were wholly satisfactory, but then nor was the underlying situation.

In assessing the nature of the restructuring needed – and the possible demand for new money – banks often face an information gap. The first step is then to gather reliable information – about how much the country has borrowed, from whom and on what terms, as well as about its ability to service its debt. This is often more complicated in larger countries which borrow through more different vehicles, and where it may be hardest to track down what the private sector has done. Worst of all are those countries whose banks have borrowed in the interbank market, and passed the foreign currency back to their governments. Smaller countries often show a woeful lack of control of their foreign borrowing; in some cases the lending banks are the only reliable source of information.

Given the information, the banks must decide whether the problem is too much borrowing in total, or just bunching of maturities. Usually – at least at first – the latter seems more likely, and is certainly more palatable. The banks will then aim to solve the problem by spreading out the repayment schedule, perhaps giving several years grace, or at least small initial amortisation, so that the rescheduled debt does not fall due in years which contain heavy maturities. Often, too, any rescheduling coincides with borrowing from the IMF, World Bank or other regional development banks; while these loans are rarely available to service bank debt directly, they provide an indirect source, since they can finance essential imports and allow cash flow from other sources to service debt. The IMF, in particular, can also provide advice and impose conditions of economic management; these are usually necessary to convince banks that a rescheduling – and particularly any new money – will in fact lead to a longer term repayment of their debt.

Unfortunately, the short term approach has not always proved successful. A few countries, such as Turkey and some Eastern European countries, have made great strides to recovery. In others, the reasonable expectation of a recovery in the price of a key export (copper for Zaire, for instance) has proved wrong; in others, the very high interest rates and strong dollar in the early 1980s outweighed the impact of any improvement in economic management; in yet others an initial improvement has caused such a social or political strain that the countries have failed to maintain the effort. Sluggish growth in the developed countries (apart from a brief but dramatic spurt in the US) and a worrying trend towards protectionism have not helped.

At the time of writing the whole approach to the problems of sovereign (and particularly lesser developed) credits seem thus to be in a transitional phase. The banks, both before and after the 1982 Latin American crisis, have developed an approach which deals with the immediate crisis; only as that begins to pass does the longer term nature of the problem become clear, and banks are still wrestling with how best to handle this aspect.

A well managed country may recognise a potential cash deficit well in advance and approach the banks (either as a group or more often individually) with a properly prepared programme and request for additional loans to enable it to avoid rescheduling. This situation is much easier for the banks since the country is neither in, nor directly threatening, default; it is probable that it has worked out a reasonable programme for repayment of all its debt, so that it is merely spreading payments which have become too tightly bunched over a longer period. This is a sensible precaution which most banks would advise their customers to take, and to which they can therefore readily agree.

9 Experience in International Lending

This chapter tries to identify lessons to be learned from experience of international lending. It looks briefly at experience since the early nineteenth century, but the main emphasis is on more recent experience and on a comparison with domestic lending. While the early sections depend largely on published material, later sections reflect conversations with international banks.

HISTORICAL EXPERIENCE: 1800–1939

As outlined in Chapter 1, many international banks or branches were opened and closed again very rapidly in this period. For instance, between December 1920 and June 1926, 74 out of 187 overseas units of American banks including special foreign banking corporations were closed. Few were over five years old. All the independent foreign banking corporations either closed or were taken over by domestic banks. However, during the same period 5,441 banks failed in the US, averaging one failure a day at one period. Similarly, during the nineteenth century the many failures of international banks in Britain were fully matched by the steady failure, merger or reorganisation of domestic banks, so that perhaps the risks in international banking were not exceptional.

At least two difficulties experienced in the nineteenth century still cause losses today, even though faster communications may have reduced the difficulty of dealing with them. The first is the lack of experienced management. This was true at headquarters, so that many banks founded with a great fanfare either never did any business or failed within a year or two. The inadequacies in this area were aggravated by lack of experienced local managers and by lack of proper controls, or the people to operate them. This was naturally worst when international banking was in its infancy, since there was no pool of experienced managers anywhere, but it recurred as each new surge of international banking outran the experience available. Commentators between the First and Second World Wars contrasted

American management and local knowledge unfavourably with that of the well established British banks.

Examples of the results of poor management include: a loss of £230,000 by the London & Brazilian Bank in 1869, which was largely blamed on incompetent managers in Rio and Pernambuco; in 1864 the near ruin of the Bank of Egypt due to imprudent loans of £162,000 by local managers to an Egyptian prince; in 1875, the loss of £171,000 by the Hong Kong Bank due to unauthorised investment by its London managers. In 1874 Deutschebank decided to close its Far East branches because it could not control them at such a distance.

The Egyptian prince highlights the second major difficulty, which was arbitrary acts of government or of powerful individuals. The London & Riverplate Bank had £18,000 of bullion forcibly seized but this was recovered by diplomatic action. In 1919 Mexico required all banks to be liquidated if their reserves were less than capital and in 1932 the Chilean junta confiscated all foreign currency deposits.

Prudent management was made even more important by lack of financial information, which also made local knowledge vital to sound lending. In a number of cases this lack of knowledge (and of proper controls) allowed an excessive concentration of risk in speculative areas. The Anglo-Austrian Bank lost heavily by financing excesses (primarily speculative real estate banks) prior to the crash of 1873, although it survivied and became internationally recognised. The English and Swedish Bank, founded in 1864, was making heavy losses by 1866 with nearly 20 per cent of its capital in loans to iron and steel plants and sawmills on the verge of insolvency, and in large advances on shipments of iron ore to English companies which failed. This bank was liquidated in 1867.

By contrast, Baring Brothers did a large business in the US and survived a series of financial crashes there, due to closely controlled management, a first class agent in New York and, above all, the meticulous collection of credit information, monitored personally by the senior partners. With no reliable financial statements, credit analysis as it is known today was not possible, and great reliance on the character and quality of individuals was unavoidable. Barings often managed to find out the capital of their borrowers or correspondents; however, their main basis for judgement was their own experience on how payments were handled, backed up by conversations with a wide range of contacts. These supplied information on how many bills each bank had on the market, how promptly it paid and whether it appeared to be overtrading. (This type of information, while no longer the main basis for decision, is still a key indicator to the integrity and ability of management, in turn a key factor in credit decisions.)

Barings also experienced some of the risks of lending to governments or their subdivisions. In the crisis of 1839–42 Barings' agent, Mr Ward, worked hard to support the credit of American states and banks with which Barings did business and whose bonds Barings held or had sold in the London market. Ralph W Hidy describes the qualms felt at the thought of foreign banks bringing pressure on defaulting states, among which were Maryland, Pennsylvania, Illinois, Louisiana, New York, Mississippi, Indiana, Florida and Arkansas. (See R. W. Hidy, *The House of Baring in American Finance & Trade*, in the Bibliography.) The argument discussed in Chapter 3 on the importance of maintaining or re-establishing credit was used as the crisis eased, and in most cases the defaulted debts were ultimately repaid. But this experience led to the establishment of the Council for Foreign Bondholders which remained in existence until the twentieth century. Similar bodies have been active since the second World War in recovering defaulted bonds and bank loans of states and cities, including some now behind the Iron Curtain.

By the early twentieth century the European rush to establish overseas banks was ended. There were still periods of excesses, but the main banking nations in Europe, having established their overseas banking networks and having developed, both locally and in head office, the skills to avoid the worst errors, were intent on consolidation. But it was only after the First World War that American banks first became seriously interested in overseas representation reflecting the changes in banking law described in Chapter 1. Clyde W. Phelps (see *Foreign Expansion of American Banks* in the Bibliography) gives three main reasons for the initial failure of American banks internationally: unduly rapid and unwarranted expansion; the lack of trained managers and credit information in foreign branches; and excessive optimism at home. He characterised it as 'a story of mismanagement, failures and fraud'. In an earlier passage his comments on consortia banks might have been taken from a magazine article in the 1970s. He felt that each owner would believe that the business generated by other owners which ought to be available to the consortium was being diverted, or that each owner would feel shortchanged on the business channelled to its shareholders by the consortium bank.

FROM 1939 TO THE PRESENT

Losses due to the Second World War, and currency restrictions in the immediate postwar period, sharply cut back international lending, as well as international trade. Apart from limited lending by Britain, France and Holland to former colonies, most international lending was directly linked to the promotion of trade; most of the exceptions came from New York. However, as outlined in Chapter 1 the eurocurrency market was probably born around 1957 and began a period of dramatic growth in the early 1960s. The nature of the market in the early phase and the small base meant that significant bad debts took some time to appear. While there are no statistics, between about 1963 and 1969 any sensible bank ought to have been able to lend eurodollars with less risk than domestically, even though worldwide economic stability reduced domestic losses in the same period. In the US, for instance, Dun & Bradstreet show the average failure ratio for the period 1946–68 as less than half that for 1857–1968.

Apart from special situations, it is only since about 1970 that eurodollar loans have been made to borrowers which carried any real risk of substantial bad debts. And because few banks make loans which cause immediate losses, there was bound to be a pause before the bad debts actually began to appear.

For all of these reasons it seems likely that during the 1960s and the early 1970s, loan losses from international lending were, for most banks, proportionately much less than on domestic lending.

There were of course some well publicised disasters during the 1960s and 1970s. The Di Angelis or Salad Oil scandal was a direct result of fraud. Although some European banks probably financed their involvement with eurodollars, it was not a specifically euromarket disaster. Apart from illustrating that there is no complete protection against fraud, it is also interesting to note the ripple effect that a major failure can have. Even banks which had refused to lend to Di Angelis lost money when he dragged down customers, brokers and suppliers with him.

The first widespread examples of losses in postwar international lending came in property. Four Seasons probably affected the bond market more than the banks and arguably had no justification for international borrowing. The fact that Penn Central had considerable problems was, to put it mildly, no secret. It was an example of the dangers of letting a famous name override normal prudence; perhaps too, foreign lenders forgot that domestic banks can get locked into a local situation where international banks need not; maybe, too, they assumed that because their own governments would not feel able to let such an important company fail, neither could the US government. Whatever the reason, Penn Central provides a lesson which no banker should need to learn: that voluntary loans to a company known to be sick do not justify the risk.

More recent and widespread examples of losses in international lending come from property. The property boom and bust in the UK (and unsuccessful European ventures by British property companies) trapped many international banks with branches in London. More culpably, some banks without London branches were also caught. The American real estate investment trusts (REIT) attracted substantial lending from the eurodollar market. In both cases, many inexperienced banks were attracted by the high margins and the secured or otherwise 'safe' nature of the loans. The question 'why are the margins so high if the loans are safe?' (equally valid in domestic and international lending) seems not to have been asked; the obvious answer, that margins were high precisely because loans to finance property usually involve a fairly high risk was therefore ignored. Property may well, as with shipping, provide opportunities for a knowledgeable lender, with a well spread portfolio, to make a satisfactory profit after absorbing the inevitable losses. But the stress is very much on knowledge and diversity of risk. A lender whose portfolio is too small to justify the cost of specialist knowledge is likely to end up with the weaker loans and faces disproportionate losses. Nor are the skills of property lending automatically transferable between countries. Some American banks sent US property experts to their London operations. The 'superior' expertise proved to be largely irrelevant because of differences in the two property markets, but the experts had to justify themselves by making loans; the results are common knowledge.

With the exception of Di Angelis, the borrowers so far discussed were primarily domestic in nature. They lacked the clear justification for borrowing internationally which banks should require. At the very least, banks should be satisfied that the requirement to borrow internationally is not a reflection of the reluctance of domestic banks to lend.

There are three natural areas of international lending which are causes of major actual or potential losses. The first is shipping (discussed in Chapter 4), which unlike property is inherently an international business. While bankers specialising in property and shipping each deny it, there are significant parallels between the two. The most important is that both finance themselves through mortgages on capital assets. Specialists tend to regard this as somehow better than unsecured corporate lending; they feel they can always recover something on their collateral. This ignores the risks inherent in a narrow source of repayment, compared to the cash flow of most industrial companies. If the source fails the capital asset loses much of its value; on the other hand, even companies with one product have a variety of customers and their assets unless pledged to other lenders (see comments on negative pledge in Chapter 7) have value in liquidation. The necessity for knowledge and diversity applies as strongly to shipping as to property.

The first major difference is that since property cannot be moved it is tied to economic conditions in one country and often one industry or borrower. Ships can move all over the world, and some (not all) can shift between different trades, thus reducing their vulnerability to one economy or industry (although by doing so they can spread the difficulties of one trade into another). Despite this, almost all aspects of shipping remain cyclical and skill is required to ride the cycle without heavy loss. The second difference is that ships have a maximum useful life of about twenty years (often less) and will normally not be built unless they can show a handsome surplus over cost within that period. Charter hire in most favourable periods will thus cover full payment of principal and interest over a normal five - to seven - year bank loan. Even in modestly favourable conditions, enough of the loan can be amortised so that the remaining risk should be acceptable, given that if there are no profitable charters when the first ends, there will be little or no new building. Thus the expectation that supply and demand will come back into balance while the ship is still relatively modern will support the capital value.

The normal cylical dangers inherent to this industry have been exaggerated in the last decade by two special factors. The oil shocks of 1974 and 1979, and the resulting recessions, created a deeper and longer lasting downward phase in the cycle. A mild recovery in the late 1970s was not enough to allow shipowners to rebuild their cash postions or obtain profitable long term charters; as a result they were ill-prepared for the prolonged downturn in the first half of the 1980s. This still continues into 1987 with only tentative signs of recovery; many observers are prepared for even worse conditions. The situation was aggravated by a burst of new building, often at subsidised prices or for political reasons. Many ships thus came into service during the recession, aggravating its effects and delaying any recovery for several years.

As a result, there already have been several well publicised bankruptcies, and many lesser ones; many previously well regarded shipowners are struggling to survive, and even the strongest are worrying about their position by 1987–8 if conditions do not improve.

The longer economic life of property makes it unusual for rental income to provide meaningful amortisation for a normal bank loan particularly where (as in a number of countries) rents are reviewed periodically or increase with inflation, so that the initial return on investment is relatively low. Banks thus rarely pay much attention to rental income as a direct source of repayment of property loans – indeed, perhaps, they pay too little. In different markets they may provide bridging or construction finance against a firm takeout, or lend expecting repayment from sale of the property or longer term borrowing.

However valid the comparison in other respects, shipping is an inherently international business and property is essentially domestic. Shipping must borrow from international banks, property usually need not, so that an extra reason is required before international banks lend against property. A large enough overseas branch lending 'domestically' may be able to develop knowledge of the market and an appropriate spread of business but generally international banks should beware of property.

The second area is the lesser developed countries or LDCs. (Individual developed countries occasionally cause concern, but are not a worry considered as a group; some Comecon countries were a major worry in the early 1980s and still warrant a wary eye, but on the whole their problems appear to be under control.)

For this purpose LDCs can be considered as two groups, the pre 1982 and post 1982 countries, although the division is not in fact as precise as that. Pre 1982 problems were mostly single countries, distinct from one another, with problems relating to their own specific circumstances and with little private sector borrowing; their total borrowings from the banking system posed little threat to the system's stability. They included a number of African countries, Turkey (probably the most successful recovery of this group), North Korea, and one or two others. The banks dealt with each situation on an ad hoc basis, although with a developing consistency of approach. Despite individual problems, these countries as a group do not threaten major losses to the system generally, whatever may be the risk to specific banks.

The post 1982 countries (mostly in Latin America) have more in common with each other than the pre 1982 ones. Most have a sizeable private sector; economic and political management which has been more inclined to government intervention, protectionism and subsidies than more successful LDCs; democracy is at best weakly established (or under threat, where it exists at all); and they have borrowed vast amounts of (mostly) dollars from the banking system. Usually both public and private sectors (sometimes including banks) have borrowed and this has complicated debt restructuring. Finally, whatever the other underlying weakness, they suffered severely from the high interest rates and the strong dollar in the first half of the 1980s.

These countries as a group (and in a few cases individually) could do severe damage to a wide range of banks, and thus to the whole interlinked banking system, if they repudiated their debts. The initial round of rescues and economic recovery measures were successful in the short run; this was helped by the boom in US imports which was the counterpart of the strong dollar. This period also allowed many banks to improve their capital position and at least start to establish reserves against possible losses. It is still far from clear whether the major countries in the group will recover. Mexico, Brazil and Argentina have shown contrasting patterns of behaviour, Mexico's excellent start seems to be being lost, while Brazil continues to improve but defies the IMF and Argentina, after a slow start, has taken dramatic and initially successful action to turn itself around.

A major worry with all of these (and other countries) is about their will, as well as their ability, to repay. So far no country has repudiated its debts; Peru has announced that it will use only 10 per cent of its exports to service its debt (but, while inadequate, this would in fact be an increase on what it had paid in the previous period). In a number of countries, however, there are political pressures either to repudiate outright, or at least to follow a version of Peru's example (Nigeria and Mexico, in different ways, are threatening to do so). Even where the will to pay continues, some countries are reluctant to take the measures necessary to improve their ability to pay. In particular, the IMF approach (and the IMF itself) are increasingly unpopular.

The danger of repudiation - and, worse still, of concerted repudiation by a group of countries - is thus a continuing concern. Banks, central banks, the IMF and other bodies recognise, too, that the initial treatment of the problem as a short term liquidity crisis was too optimistic and are settling down to a much longer recovery period.

The inability to bankrupt a country makes it difficult to assess the risk/reward ratio. At the moment, different banks have taken more or less conservative approaches to reserves; it is, after all, a matter of opinion whether a country can, or will, eventually pay its debts - at least until it formally repudiates them. Even then there is always the chance (however theoretical) of a change of heart; banks can never say of a country, as they can of a fully liquidated company: 'We have realised all the assets this borrower possessed. There is no further possibility of recovery from any source and our unpaid debts are by definition a loss'.

Nevertherless, there is a gradually developing market in debt of problem countries, at discounts which reflect a balance of views about recoverability (although even this means that the buyer usually expects to recover more than he pays). This market covers both outright sales and simple or sometimes complicated swaps. With a sale, the bank establishes its loss, and must take it at once; even if the borrower repays in full, the seller no longer benefits. With swaps it is more complicated. For instance, a Spanish bank might accept $1 million face value of debt from a troubled Spanish company, and in return give a US bank $1 million of Latin American debt; this could just mean that each felt it easier to follow the debt it received than that which it gave up, and that they applied the same discount factor to both borrowers. The swap thus does not indicate the size of the discount.

In more complicated cases, banks may use one or a series of swaps to build up a holding in a particular borrower's debt at a cash cost to them of say 65–75 per cent of face value.They can then offer to sell it back to the borrower at say 80–85 per cent of face value. This allows the bank to take a profit while making what amounts to an equity contribution to the borrower; this may even improve the quality of other debt from the same borrower.

However, while the swap market may quantify and spread the loss, and allows skilful traders a profit, it does not prevent the banking system as a whole losing money; nor does it eliminate the uncertainty as to what the final loss will be. It may, however, strengthen the growing tendency for regulators to require minimum provisions against certain countries.

The third major area which has already caused heavy losses - and threatens more - is oil and related industries. The early losses were mainly domestic US (Penn Square being the most notorious) and came heavily from borrowers servicing the drilling and exploration side of the industry. However, OPEC's failure to cut supply by enough to offset the growth of non-OPEC production and a slowdown in demand put gradually increasing pressure on crude oil prices. Banks have been doing calculations on many North Sea and other offshore oil wells, financed on a project basis, to see at what price level proceeds of the project fail to service the debt. None have failed, at the time of writing, but as the price goes below $15 per barrel, an increasing number are threatened. The exact outcome in each case will depend on five main factors: the structure of the original loan (and in particular the reserve coverage); the operating costs of each well; the timing - i.e., whether any worthwhile amount of debt has been repaid before the oil price reached the critical level; whether the lending banks believe the price can recover far enough, soon enough, to make it worth supporting a well temporarily; and whether interest rates fall pro rata, thus reducing the cost of debt service.

There are of course many corporate borrowers whose ability to service debt is at least partly dependent on oil prices, and at least two major country borrowers - Mexico and Nigeria. There are even more who suffered from the original price increases, and will benefit.

GOVERNMENT ATTITUDES

Different governments take different attitudes to major corporate insolvencies and bank failures. Some may choose to protect particular companies for reasons such as the threat of unemployment (largely domestic); others to avoid damage to the country's defence effort and/or lead in a technical area (domestic and international); yet others for political and economic prestige (again domestic and international). Unfortunately, there are no guidelines as to which companies will be saved or why. Each country has its own priorities which may differ with the party in power, or even according to the parliamentary constituency in which a company is located.

For instance, the Bank of England rescued Burmah Oil in the 1970s, arranged a lifeboat for the fringe banks in the same period, and bought Johnson Matthey Bankers in 1984 to save the gold market from collapse. It would probably repeat the fringe bank rescue if that became necessary; the change in political climate under Mrs Thatcher, and the political furore generated by the Johnson Matthey Bankers' rescue, make it unlikely that it would repeat either of the other two efforts. Instead, it now has an active industrial department which watches over the way the banks handle major problems and occasionally brings pressure on recalcitrant banks to accept a scheme they do not like.

In Germany Herstatt was allowed to fail in a way that many people, including the German courts, thought was outrageous. Hessische Landesbank was saved from collapse due to unsound domestic lending only because it is owned by the state government; the state prime minister's career suffered as a result. AEG was supported by the banking system until the cost finally became too great, and it was allowed to go through Vergleich, the German reorganisation process for bankrupt companies.

In Switzerland the authorities were certainly prepared to support Credit Suisse after Chiasso, although it proved not to be necessary. But smaller banks in Switzerland have been allowed to fail and it seems unlikely that industrial companies would be willingly supported. The French government for long supported ailing industries such as steel and textiles, but also restricted many companies' ability to cut excess manning. The Mitterrand government then nationalised many of the problem companies, and found their losses so huge that it had to change policies. Cruesot Loire was allowed to go bankrupt, private sector companies such as Peugeot were allowed to lay off people and close plants to avoid the need for subsidies; finallye even state-owned Renault was allowed to do likewise. France is not the only country, moreover, where state restrictions have caused (or aggravated) industrial problems which the state has then tried to solve with subsidies. This seems to be becoming a less popular approach, however.

In Italy, the support of a whole range of companies through state holding corporations became too expensive; some are now being partly sold to the private sector, while others are under pressure to improve efficiency; it is much less likely that the holding companies would now simply buy any company in difficulty to avoid loss of jobs. In Spain, a similar change in attitude is at an earlier stage; however, in rather unusual circumstances Spain allowed a partly government-owned group of companies to go into Suspension de Pagos. In the private sector case of Union Explosivos Rio Tinto, the Spanish government contributed modestly to the rescue only when the banks had worked out a restructuring. This assured the company's survival at considerable cost to the banks. In Japan, smaller companies have always been quite ruthlessly allowed to go bankrupt; larger companies were often saved if they were considered part of Japan Inc. but others were allowed to collapse. The Japanese banks often get heavily involved in restructuring troubled companies and appear to accept that if they are to have a free hand they must protect other creditors; Industrial Bank of Japan, in the 1970s virtually guaranteed Japan Line's charter obligations, although there was a moratorium on bank debt. More recently, however, the burden of supporting troubled companies has increased to a level which is sometimes unbearable; even the Japanese banks could not face the cost of continuing to support Sanko Steamship.

Finally in the United States when the US National Bank of San Diego and the Franklin National Bank failed the FDIC protected small depositors and 'legitimate' creditors, but took a tougher line with professional lenders, who it felt should have known better. In the early 1980s the number of bank failures in the US increased dramatically, but Continental Illionois was too large to be allowed to join them. And while the US government rescued or helped Lockheed and Chrysler, Penn Central was allowed to go bankrupt, and more recently International Harvester and many lesser but substantial names have had to seek their own salvation.

There thus are unquestionably cases in any country where governments will rescue a company or industry, but these are often for unpredictable reasons and creditors are not always protected. A new government can have different views as to priorities, as with the Heath government's (short lived) policy of letting 'lame ducks' die, or the change in policy in France following the 1978 elections, and Mrs Thatcher's more robust version after 1979, or the switches under

President Mitterrand. Finally, since even the domestic market may misread a government's likely reaction to particular companies, international banks can have little confidence in their ability to judge this correctly. The concept of Japan Inc. or Great Britain Ltd can save banks from losses in particular cases but it is hard to justify an argument that banks should lend on that basis.

RELATIVE RISK/REWARD RATIOS

There are major difficulties in comparing the risk/reward ratios for international and domestic lending. No banks publish complete statistics on the profitably of lending and only American banks publish any information on bad or doubtful debts, and recoveries, which are broken down between domestic and international. American banks provide information on which a partial comparison of net interest earnings in domestic and overseas branches can be based. Unfortunately, it is possible to relate only the cost of time deposits, not all deposits, to the yield on loans; the figures are given on a 'tax equivalent' basis, and it is not clear how this affects the comparison. Not even American banks provide a breakdown of other direct income from lending (such as syndication fees or acceptance commissions) which tend to be more important in international than domestic lending, although this may be offset by the larger propor tion of interest free deposits in domestic rather than international business. And no bank can even identify which of the ancillary earnings or assets (deposits, exchange business, collection, money transmission and securities business, to name a few) represent a reward for internatioanl or domestic lending, and which merely recognise the quality or price of the particular service, or are a reward for other services. Nor can costs, other than interest, easily be allocated between domestic and international business or even between lending and other activities.

Statistics from the annual reports of American banks in the Appendix broadly suggest that the experience of bad debts is consistently lower for international than domestic lending; in both periods covered, however, international seems to recover a lower portion of amounts previously charged off. The comparison of net interest earned is more variable, but on the whole international margins did not compare too badly in the first period. The more recent figures, however, are less favourable to international, although there is a tendency for the gap to be lower in 1985 than in 1982; perhaps this shows that competition was spreading from international to domestic market. Perhaps, too, the size of the gap reflects the growing importance of fees in the international markets during this period. However, both these comments must be very heavily qualified in view of the partial nature of the statistics.

There was at one time a general assumption, particularly among American commentators, that international lending is both more risky and less profitable than domestic lending . This assumption was not usually supported by any evidence, since what little there was seems to show the opposite, and was sometimes cited without apparent recognition of the contradiction. For instance, in evidence to a subcommittee of the US House of Representatives in March 1977 Henry C. Wallich, a governor of the Federal Reserve, said 'Nevertheless, the expansion of the banks' international activities has necessarily been accompanied by greater risk exposure'. However, a few paragraphs later he gave figures showing that in 1971–5 the international losses of the seven largest US banks were only one third their domestic losses (as a proportion of the loan portfolio in each case). Even in 1975 and 1976, when all types of losses rose sharply, international losses remained substantially below domestic losses. During the late 1970s and early 1980s this assumption diminished somewhat but came back in full force with the troubles of the Comecon countries' and particularly Mexico and other Latin American countries. Commentators make little distinction between risk and actual loss, or types of risk.

Domestic markets vary in strength and sophistication, in severity of competition, in profit margins and in the economic growth and opportunity for safe lending. Thus, even if domestic lending were safer and more profitable than international lending for American banks this would not necessarily be true for other countries.

There are a number of theoretical reasons making international lending either more or less risky (or more or less profitable) than domestic lending. A summary may provide useful background to comments from banks on their actual experience, and some of the factors to which they attribute that experience.

Probably the strongest argument in favour of international lending is diversity. Particularly for a bank based in a weak economy or for a regional bank, international lending spreads the risk over a rânge of economic conditions and reduces dependence on the economic performance of one country or region. It also enables the bank to provide a wider range of facilities to its key customers; this type of diversity provides protection against competition.

Other favourable features are the ability to be more selective and to run a mainly wholesale business. Domestic banks are part of the social and economic structure of their country and often have little choice as the type and size of proposition they must consider. The local grocery store and the farmer must have access to banking services. Although banks can often more than compensate for the additional risk by higher interest and by the local knowledge of their branch managers, at best both sides of the risk/reward ratio are higher. Moreover, the overhead costs of a domestic branch network are increasing in most countries. International banks have greater flexibility and can avoid high risk business and contain overhead costs by selective placing of branches, limitation of services, and by making relatively few, relatively large loans. However - particularly for banks with new or expanding operations - the need to break into a market against entrenched competition can pose some difficult choices. Unless a bank has special skills to offer and is prepared to market these patiently over a lengthy period, it may be faced with the choice between accepting inadequate interest margins or unsound credit risks (or both) in order to put enough business on the books to cover even its lower overheads. British banks have long felt that foreign (particularly American) banks cut rates very severely to break into the UK market. Ironically, American banks are now making the same complaint about the invasion of foreign banks - in which the British are among the leaders - into the US market. Much the same comments apply to the various types of capital market products, except that in some cases the banks are taking excessive trading or marketing risks as well as (or instead of) credit risks.

Only rarely are international banks the major lenders to a company, and often they are not even a significant factor in its total borrowing. This has conflicting implications: the bank is likely to have less influence on the management of the company and be less able to keep itself fully informed, or to take remedial action if it sees deterioration setting in. On the other hand, its smaller exposure may make it easier to withdraw; recall of larger facilities runs the risk of pushing a company over the edge, thus proving self-defeating.

The risk of political pressure to continue lending into a weak situation and against a bank's better judgement is a delicate subject. Local banks may be subject to much greater pressure as part of the local scene, while the authorities may accept that foreign banks do not have the same obligations to the national interest and/or that to force foreigners to continue to lend is damaging to the country's standing in international markets. On the other hand, central banks can make it clear that a banking licence goes to 'co-operative' lenders (or banks may lend in case the central bank might take that attitude, even where it does not); and the temptation for a left wing government, in particular, to blame redundancies or more general unemployment on a foreign 'bankers' ramp' is severe.

BANKS' VIEWS

More banks in 1986 appear to believe that international lending is riskier than domestic than at the time of the first edition. However, those that believe this without qualification are still quite a small minority; a slightly larger group distinguish between sovereign lending (or in some cases any lending to LDCs) and lending in OECD countries, which they put on a par with domestic lending. While many still accept diversity of risk as an argument in favour of international, most feel that competition has undermined the ability to be selective. Those believing that international was riskier paid less attention to the mistakes of high flying but inexperienced executives, or even to the greater difficutly of establishing close relationships; on the other hand, even those supporting international stress the need to have an operation in the borrowing country, and the danger of assuming that things work the same way abroad as they do at home. More value was put on the ability to bolt in international lending as well. Finally the greater average size of international loans – and the greater publicity value of losses – has been given greater weight by the actual or presumed losses in lending to LDCs; the impact such publicity can have on a bank's own credit standing is very painful.

There has been thus a shift in banks' perception of the relative risk of international lending since the time of the first edition. It relates particularly to sovereign lending; for OECD lending some of the doubts about definition discussed below apply to risk as well as to profitability. Moreover, almost nobody came out unequivocally in favour of international lending being the more risky; most merely felt there was little difference between the two. Opinion on profitability also tended to move against international, although only a few banks were willing to give a firm view, partly due to difficulties in definition.

Most interviews were held in London so that, apart from those of British banks, the views were as seen from a branch, even though the individuals might have some knowledge of other branches or head office. From head office, any lending from an overseas branch is international, but from the point of view of a long established branch network - such as those of the European overseas banks, and a few branches of American banks - much of its lending may be 'domestic' to the country in which it is located. The head office might thus distinguish between its domestic divisions at home, and its international division and overseas branches; the branch might distinguish between its sterling or peso lending to British or Mexican companies, and its trade financing or eurodollar dealings. (This difference may also have an effect on the attitude of the branch to the analytical techniques discussed in Chapter 2. If the London or Mexican branch of an American bank feels that it is doing a domestic British or Mexican business, it may follow the domestic pattern of lending against security with limited analysis of figures, rather than the going concern analysis its head office uses.)

An equal cause of confusion in assessing profitability is the allocation of operating and management costs and capital and bad debt reserves. The allocation of capital (and consequent reduction in interest costs) between domestic and international operations varies from bank to bank, and is not disclosed; the same is true for the allocation of the cost of reserves for bad debts. Some banks deduct a standard allowance for bad debts from interest in assessing profitability. This allowance may be the same for all loans (in which case it tends to distort reported profitability in favour of the riskiest loans) or may be adjusted to reflect actual experience; some banks assigned a reserve cost in accordance with the ratings discussed in Chapter 6. The charge may reflect subjective judgements with a risk that the reserves allocated against international lending are too high, either because of the bigger and more visible individual losses, or because management does not feel confident that it understands, say, shipping loans, and therefore provides on a more conservative basis than on other equally dangerous but better understood loans.

There was some disagreement among banks whose branches had 'domestic' aspects as to whether higher risks were inherent in some local banking systems but compensated by higher returns, or whether risk and reward in such countries were largely separate, with risk depending mainly on the quality of local management. But most banks with this type of branch network agree that the related non-lending business (including foreign exchange, collection and payments) generated by financing international trade for 'domestic' customers in these countries adds substantially to profitability.

Two main points were cited in favour of international profitability in the first edition: the ability to spread operating costs because of the wholesale nature of international lending, and fees. The pressure of competititon on margins has almost eliminated the first, but fees are still important. However, these too suffer from competition, and only the largest or most innovative banks can gain enough of an advantage to boost their profits to the level of the best domestic.

However, many banks either felt that even domestic profits were under great pressure or distinguished between those part of their domestic business which were subject to competition from international banks, and those which were not. One British bank referred to 'North of Watford'. Banks which felt that their domestic margins remained above international levels either operated in relatively protected markets or agreed that nationalist tendencies acted as a form of protection. Smaller banks suffer both from poor access to fees and from the difficulty of breaking into a protected or nationalistic market; there is no doubt that some tiering is developing between those which can find a way of earning fees from arranging loans and those which merely take a part of what the big banks offer, whether in syndicated lending, NIFs or anything else.

The effect on profitability of a capital base denominated in a weak currency seems less important than at the time of the first edition. This may in part reflect the greater availability of capital or near capital in dollars, through subordinated and perpetual floating rate note issues, swaps and so on; or it may just mean that the other problems are so much greater that the capital mismatch no longer warrants a mention.

In brief, the continuing pressure of competition on margins and other forms of profit from lending is no longer confined to international lending. Some domestic markets still have an advantage over international, but others either do not or have it only in segments not subject to foreign attack. Not only do we need to define international lending carefully; we also need to specify which domestic market we mean.

SUMMARY AND CONCLUSION

There is thus no clear evidence - either statistical or anecdotal - that domestic lending is riskier or less profitable than international, or vice versa. The effort to compare and contract, however, does suggest some lessons. These ought to be second nature to bankers, but they do seem to get forgotten; it is dangerous to forget them at home or abroad, but both easier and more dangerous abroad.

The basic principles of sound lending thus apply just as much internationally as domestically; the penalties for ignoring those principles may be harsher internationally. In order to apply them, both domestic and international banks need well trained staff, sound internal controls and procedures, alert management, recognition of areas of higher than usual risk and of the need for specialised knowledge to assess and follow these risks. Domestic banks have a pool of staff trained in relatively stable banking conditions, so that even rapid growth can be accommodated without undue strain. International banking - due to wars, exchange controls and the fluctuations in the growth of international trade - has been prone to rapid spurts of growth and change, followed by periods of quiescence or even decline. In addition, staff from one country cannot always easily work for banks of another nationality, so that the pool of trained staff and managers is fragmented. As a result international banks (or some of them) may expand faster, and need a larger growth in trained staff, than is available. The wider variations and more rapid changes in the nature of international business require a greater variety of skills and a more adaptable staff. Unless all this is recognised, business may expand beyond the capacity of staff and controls to manage it, with expensive results.

The last paragraph, taken direct from the first edition, has had its validity reinforced by the enormous acceleration in the rate of change in the last few years. The sheer difficulty of documenting the vast number of swaps, for instance, will eventually be mastered by things like BBAIRS agreements, master agreements covering many transactions between the same counterparties and no doubt other devices. Until these agreements have run for some years, however, we shall not know whether they contain unworkable features - or at least some so difficult to work that mistakes are almost inevitable. Equally, until a few counterparties run into difficulty (even bankruptcy), we shall not know whether the protective clauses actually work. In one sense, no prior training is available, so all banks start on an even footing. In another, however, the new products only add frills to the basic principles; those who thoroughly understand the basics are less likely to be blinded by the frills.

Two of those principles are to avoid excessive concentration and to do one's own homework. The danger of ignoring these has been illustrated in domestic as in international lending. Excessive concentration has caused losses, or threatens them domestically in cases like Penn Square, energy loans in Texas and Oklahoma and agricultural loans in California; internationally, the most obvious threat is Latin America. Penn Square also illustrates dramatically the danger of relying on another bank's homework; less clearly (but equally convincingly), do the Latin American loans. Too many smaller banks seem to have relied on the name of the manager, rather than on their own analysis. There must be a real fear that the same will be shown to be true of LBOs.

Although the principles may be similar, the details of international banking differ widely, not only from domestic banking but from sector to sector and market to market. Detailed knowledge of each sector and of local law and practice is thus required at one level. At a higher level, there must be a breadth of experience and elasticity of mind (as well as of controls) to ensure that compatible standards exist throughout the bank, and that the detailed implementation of those standards is both sufficiently flexible to adjust to the different conditions, and sufficiently sound to be understood at all levels, and to be effective.

There is also a need for humility. International lending is not easy, even though it sometimes looks it. Domestic banks sometimes look sleepy and their customers ripe for picking, but even when this is true they usually have inherent strengths which enable them to fight back effectively. Moreover, they are rarely as sleepy as newcomers think; rather they may prefer to 'miss' an 'opportunity' which they recognise as a trap. The lender who applies his experience out of context without recognising that fact will often fall into the trap.

Finally, credit analysis may be harder in international lending, because of different accounting treatment, lack of information or other reasons, but it is even more necessary.

In brief, the principles of lending do not change very much, although individual skills and individual risks do. However, it is easier to make a silly mistake in international lending, and the punishment is liable to be much greater.

10 The Outlook

All aspects of international banking are in a state of flux, making the overall outlook unpredictable in detail. There are, however, several key areas which will influence the shape of lending over the next few years. While there is some linkage and overlap between them, they are conceptually distinct. These key areas are lesser developed countries (LDCs); securitisation; the effect of competition on margins and credit standards; capital adequacy among banks; regulation and deregulation; and perhaps LBO's and junk bonds.

LESSER DEVELOPED COUNTRIES (LDCs)

Until 1982–3, no single country or group of countries seemed likely to default for amounts which would threaten the stability of the system, or even any major bank. The nearest to such a threat had come from Poland and other Comecon countries, but this appeared to be under control.

In August 1982 Mexico declared a moratorium on its debt. This created a Latin American panic which forced many other countries in Latin America to reschedule. Some (perhaps most) would have reached this stage anyway, but the speed with which they all began to restructure put enormous pressure on the banking system. Default threatened on loans which for many banks were more than – and in some cases a multiple of – capital. The larger potential defaults involved tens of billions of dollars and hundreds of banks each, were immensely complex, and stretched the banks' human resources to the limit. By late 1984–mid-1985, the first phase of the crisis had been successfully contained, but it was clear that the problem was a long term one. The initial successes were important in several ways, but following them up was going to be difficult.

The banks are using their breathing space to improve their ability to withstand a major default, or even a series of them. Many banks have raised large sums of new capital so that problem loans (in total or to particular borrowers) are a smaller percentage of capital than in 1982. In many cases they are still too large, and the risk of a chain of defaults triggering off a chain of bank collapses remains, but there is now more hope that the banking system as a whole could survive.

Then again, the banks have begun the process of provisioning against probable losses. So far, provisions have mainly been against smaller sovereigns or against corporate loans in the larger countries. Many commentators believe that too little has been done, and some regulators are now requiring more against specific countries. Nevertheless, the process is spreading the inevitable losses over several years and enabling banks to absorb them while remaining profitable; this has both a real and a cosmetic benefit, since confidence is critical to a bank's ability to survive. The sale and swapping of loans is part of the same process.

The longer the LDCs can be kept reasonably solvent, the greater the chance the banking system will survive without a major collapse (or series of government rescues to prevent one). Nevertheless, as the successful first phase of the rescue ends, banks, governments in all parts of the world and international agencies are still groping for sound answers. Some of these answers must be economic/political and are out of the banks' control; they could, however, lobby more actively against trade protection in particular, and other economic policies which make LDC debt harder to service, in general.

But even the best economic policies in the developed world will only help some LDCs, and even then not always enough. The political and social pressures on the worst managed countries will make it harder for them to devote the necessary resources to debt service, as well as to modify their internal policies sufficiently. The failure of Mexico to follow through its initial success and the refusal of Nigeria under a series of governments to devalue, are only two examples highlighting the growing problem. Banks face an increasing danger that countries will repudiate their debt, rather than just fail to pay.

Banks, governments and international institutions must develop longer term programmes. The wave of panacea solutions seems to have passed, and the case by case approach to be accepted as the only one which has any chance of success. The Group of Five initiative on the dollar, and the Baker $20 billion loan programme are also wider attempts to help. A lower oil price will help many countries, although aggravating the problems of the oil producers; a lower dollar and lower interest rates will help almost all.

There is some danger that practical bankers are too involved with 'fire fighting' to think more broadly, and that the broader thinkers are too attached to panaceas to think practically. There is no doubt that some imaginative new ideas are needed; not single sweeping solutions, but a number of ideas which can be combined in different ways and forms to meet the different needs of each country. Borrowers need an incentive - as well as the stick they clearly know about - to dissuade them from deliberate default. One area where new ideas could help is that of new money and equity. The Baker initiative and the various suggestions for increasing the activity of the World Bank, IMF, etc. address this point, but inadequately. The sheer amount of money needed is beyond their grasp and many countries need equity, not more loans with more servicing costs.

In the corporate sense of share capital, countries cannot have equity; in the broader sense of funds which carry no mandatory servicing cost, but receive a return related to success, they can. Unfortunately, the best and most obvious form of equity - allowing foreigners to invest in local industry - is often politically unacceptable to the debtor. Moreover, once a country is in difficulty, private equity investment usually becomes unattractive, and capital flees the country, legally or otherwise.

Nevertheless, it seems clear that not all LDCs can (or will) service their debts in full without some form of equity injection. Default on loans - whether by the government itself or through the bankruptcy of large private sector borrowers - is the most painful form of equity contribution the banks can make. To avoid it, they need new ideas - not panaceas, but practical ideas, each of which will help some countries to some extent, but which can be combined and varied to meet particular circumstances.

Ideas such as asset swaps, or bonds guaranteed by (and convertible into shares of) banks which receive the proceeds of the issues to reduce debt, are discussed in *How to Handle Problem Loans*. Whether these are viable or not they are not enough; banks need more original ideas to help solve the problem. Charge offs by the banks, or even sale of assets at a discount to other banks, do not help the borrower. Sales of loans back to the borrower at a discount provide equity, but - on any scale large enough to be useful - usually require a higher immediate payment than the borrower can afford.

SECURITISATION

The development of securitised lending, and of related techniques such as swaps, has been so fast that many aspects of it have not yet been fully tested. The competition between banks which first made lending unprofitable is also making each new type of security product rapidly less profitable, and spurring banks on to develop new products. Some of these products are of real value and will remain; others are marginal and many are either pure gimmicks or of value only in special situations.

The lasting impact of securitisation on lending will depend on several factors. One is how far availability moves down market. Each new security product is offered first to the very best credits, and then to slightly less good ones. At some level, it ceases to be offered, but it is not yet clear what that level is, or whether it is the same for every product. The impact of a credit crisis on the market is discussed later, but will depend in part how far down market securitisation goes; there is also the risk that, by allowing access to the best credits only, it weakens the asset quality of bank balance sheets, providing yet one more threat to bank stablility.

The second factor is the question of who buys the securitised products. Securitisation in theory gives borrowers access to more varied sources of funds. But initially most of the paper actually ends up with the banks, so that the same group of lenders are simply distributing the risk (and the profit) of lending slightly differently. This may affect the reaction in a credit crisis, but it does not greatly affect the availability of funds. If, however, the products are largely sold outside the bank market, they become more volatile; corporate treasurers and institutional investors will (quite rightly) run at the first sign of trouble. They see this type of security as a short term investment which they can realise when they need liquidity. Tight money will thus mean that, just as the borrowers want to raise more from the market its capacity falls and only the banks can provide the funds. And yet securitisation weakens their ability and inclination to do so. The risk of borrowing flooding back onto a banking system which has not enough capital to support it is a real one.

The outlook for securitisation also depends on how it handles its first major crisis, whether a liquidity squeeze, or a credit crisis or both together. The impact of a sudden liquidity squeeze will depend partly on whether most of the banks' loan facilities are committed. If they are, the banks will have no choice but to lend to replace securitised debt and to borrowers who have conventional commitments; and to do it on inadequate margins committed in better times. This will mean a dramatic increase in the asset side of the banks' balance sheets, but no necessary ability to build capital to meet the higher requirements.

Of course, this is the worst case. If banks continue to build their capital as they have done recently, the risk of inadequate capital is less. If the change in liquidity is more gradual, and the number and quality of borrowers able to raise committed securitised debt severely restricted, the volume impact will be smaller, and the perceived quality of the new assets greater. And if the trend to uncommitted facilities which began in late 1985 establishes itself, then banks can either refuse to lend, or can lend at margins which reflect the new scarcity of money.

In a credit crisis (i.e., where one or more borrowers fails, or at least seems likely to) there are two main points to watch. One is how far the market withdraws funds indiscriminately from all or many borrowers, creating a liquidity crisis at the same time. The other is how the banks deal with the troubled borrowers.

There are conflicting assumptions behind the NIF and RUF committed facilities. The purchasers of the paper see them as short term investments which they can sell, or realise at a maturity of six months or less. The borrowers see them as medium or long terms facilities, at a short term cost. The underwriting banks make this contrast possible by accepting very low commitment fees (and low guaranteed margins). These do not allow them to build up or service the capital necessary to carry the loans - and loan losses - should they ever come on balance sheet. The inherent assumption is that the risk of loss (or even heavy usage) is small.

The validity of this assumption depends partly on credit quality, partly on a view of the market, and partly on documentation. Like conventional loan agreements, securitised lending carries events of default. In practice, these are weak for most credits signed before early 1986; but even so an event of default could happen at short enough notice to catch purchasers of paper still holding it. Tighter documentation, with ratio covenants, would make this more likely. Both borrower and investor therefore have an interest in weak events of default. (In one agreement, the underwriter reportedly must buy back even paper in default.) This in turn has adverse implications for credit standards, discussed in a later section.

This facet of securitisation also threatens the sound handling of problem loans in two ways. First, if an event of default occurs whilst a commitment is undrawn but europaper is outstanding, the underwriting banks have a greater incentive to call a default. By doing so, they avoid lending to a weakening company. The reaction is quite different if they are already lending, when precipitate action may damage their chance of recovery. Despite possible other relationships the danger of premature action by an underwriting bank is clearly greater with NIFs, etc. than with a conventional loan; the same is true of horizontal loan sales.

Where a borrower with many banks gets into trouble, it is always hard to get all banks to go along with any restructuring plan. Banks lending short term without any relationship or loyalty react with panic or anger against the borrower. With securitisation, the risk is that the bulk of the lenders, having bought europaper, FRNs or other securities, may fall into this category; some purchasers may not even be banks. Noteholders and underwriters may be fighting over who is actually responsible for the debt, which only makes it worse. And there is a trend - which some people seem to think goes with securitisation, although it is not a necessary part of it - to eliminate relationship banking. This may eliminate the hard core of relationship banks, around which a successful restructuring is usually built, and without which it may prove impossible.

This is to take the gloomy view. Until there have been problems among companies with heavily securitised debt, nobody knows how real the risk is. If the worst happens, then both borrowers and lenders will need to reassess the attractions of securitisation, or at least those aspects of it which contribute to this risk.

COMPETITION, MARGINS AND CREDIT STANDARDS

A factor in the rapid change - both towards securitisation and within it - has been the intense competition. This has had a number of beneficial effects, but threatens banks in two ways. It has undermined margins, first on conventional lending and later on each new product. Many banks can as a result no longer earn a return which services the capital base they need to support the asset and liability structure. One reaction to this has been to look for business which does not appear on the balance sheet, such as underwriting NIFs etc. The problem is that the credit risk of an underwriting is almost exactly the same as a loan; there is also an additional risk that the contingent liabilities may flood onto the balance sheet at an unfavourable time and make brutally clear that capital is inadequate. A number of regulators, led by the Bank of England and the Federal

Reserve, are thus pressing to have contingent liabilities and unused commitments counted, at least in part, in deciding capital adequacy. This may force banks to increase their commitment fees and thus make the facilities less attractive and perhaps allow a modest increase in conventional lending. However, this will require firm and more widespread action from regulators - or, which would be better, greater prudence from the banks - than now appears likely.

The impact of competition on credit standards is even more worrying. For this discussion, credit standards have two aspects - the creditworthiness of the borrower and the risks inherent in each transaction.

The overlending to LDCs and the subsequent problems are well documented. Banks seem to have learnt little from them. Lax credit standards take three forms in the initial loan - usually all three appear at once. Banks are too often prepared to lend without fully understanding the borrower - in some cases, without any serious attempt to do so. This leads to loans to borrowers who should not be able to borrow at all, or to excessive loans to borrowers who should be able to borrow only modestly, or to name lending.

Secondly, banks lend with too little attention to variations in credit quality, so that their earnings and ability to build up capital do not reflect the spread of risk in their portfolio, but only the risk of the best borrowers.

Thirdly, they pay little attention to the structure of the loan and its documentation. Customers in the euromarkets have almost completely won the battle over documentation, which now gives minimal protection to the banks even in conventional loan agreements. In particular, banks have lost all the ground on ratio covenants that they once seemed to have won. This reflects the strength of the customer's position, but also the banks' failure to focus on this aspect of credit; few banks try to educate their customers to the real advantages of covenants and of sound documentation.

Perhaps the worst aspect of this is the growing tendency of companies to draft their own agreement and present it to the banks on a take it or leave it basis. This is bad enough when it is competently drafted: it may not then protect the banks, but at least it will work, and will show some understanding of what the banks want; many company agreements do not even do that.

Standards of monitoring credits once on the books have also declined; banks have never been very good at this, but it is crucial to catching problem loans. At least conventional lending and relationship banking carried with them mechanisms which made monitoring easier. The emphasis on marketing individual products and transaction banking seems to encourage bankers to believe that risk is somebody else's problem. Even the most credit oriented banks are still groping for effective ways to monitor credit under the new conditions. Some banks seem almost to ignore risk – sometimes even before the deal is done, and certainly once it has been.

The weakening of credit standards, and of monitoring, is not quantifiable; nor is its impact on the existence and handling of problem loans. The general tendency, however, will be for borrowers to borrow more than they should, or to borrow in the wrong way, for the wrong reasons; to delay recognition of borrowers' weakness so that remedial action is taken late, or not at all; and to allow more surprise problems. When taken by surprise, banks find the necessary rescue even harder to arrange than when a problem is well flagged and they have time to think it through.

The combination of all these factors is potentially explosive. The risk/reward ratio moves against the banks, they find it harder to build up capital, and at the same time the quality of their assets deteriorates so that they need the capital more urgently. If (as often happens) the problems crystallise at the same time, the deterioration in asset quality can become evident with dramatic speed.

Again, this is painting the worst picture. Banks are finding so many different ways of funding themselves, and of charging fees for related services, that the erosion of margins may be less important than it appears; or it may mean that banks are being split into two tiers. Those that can fund themselves below LIBOR, can earn fees and perhaps can avoid underwriting or lending large shares of the deals they arrange, may well be improving their overall position. Smaller or weaker banks have less access to cheap funding, less ability to earn fees and rely more heavily on low margin lending – to credits they do not understand and cannot monitor – as a source of earnings.

One factor which may reduce the risk in many (although not all) cases is the protection borrowers can find from the new types of transaction. For example, interest rate and currency swaps enable corporate borrowers to protect themselves against fluctuations much more effectively than a few years ago.

However, each transaction carries an element of risk that is clearly related to itself, as well as to the credit risk of the borrower. An interest rate swap, after all, does not eliminate the risk of high interest rates; it merely passes it on to someone else. This may be the bank initially, but commonly the bank in turn lays it off with someone who takes the opposite view (or has opposite needs) to the original customer. In a typical interest swap, therefore, a bank standing in the middle has two exposures; if one customer fails, the bank may have to obtain a new fixed rate source and floating rate outlet; if the other fails, it may have to obtain a new floating rate source and fixed rate outlet. There is, of course no certainty what this will cost or even that it will cost anything, if interest rates move in the failing company's favour. However, if the worst happens and the bank has to find a new floating rate source, there is no way of telling, when the swap is written, exactly what the cost will be. Over a seven- or ten-year period interest rates can fluctuate enormously, even in countries which, at the outset, have fairly stable rates; in more volatile currencies, an increase from, say, 10 per cent to 50 per cent, 100 per cent or even more is conceivable, if unlikely. Thus it is very hard to use the concept of exposure (the worst possible loss under the worst possible circumstances) which is normally used in accounting for loans, and assessing their risk, capital needs, etc. All that can be done is to make a reasonable guess at the worst that is likely to happen. This might suggest a particular maximum/minimum level of interest rates, or a doubling within a given period. Whatever the approach, it must allow for the fact that the failure may happen at any time within the life of the swap; and that, although the bank cannot lose on both sides of the swap at once it can lose on first one and then the other, if interest rates zigzag. Moreover, a reasonable assumption about interest rates for the US dollar or Deutsche mark may be wholly invalid for the Italian lire or Mexican peso.

Swap agreements often contain one of two formulas for calculating loss in event of default; one relies for its validity on the assumption that a replacement swap can be negotiated, the other relates the cost to a benchmark interest rate such as Treasury Bills. Under current conditions and for major currencies, the replacement assumption is broadly valid. Nobody knows whether it would be in a period of crisis, with numerous counterparties defaulting on swaps, since such a period has never happened.

Similarly, the documentation designed to protect each counterparty to a swap from default by the other has not yet been tested all the way in court. There is a risk that banks may have to sit by, unable to enforce their right to replace a swap contract at the defaulting party's cost, while the market moves against them. All new securitised products carry a transaction risk which is different to that of a loan, and at first glance often appears less.

There is a question whether banks have worked out in each case exactly what the risk is, what is a reasonable proxy for exposure, and what is the basis of return which gives a fair risk/reward ratio. Banks more aware of risk than most are working on this, at least for the better established products; but the banking system as a whole may not be, although the regulators began in 1986 what looks like a concerted effort to make them do so.

It may yet turn out that the risk is as small as the returns banks are prepared to accept suggest, and that there is no prospect of a concentration of failures creating new types of risk which banks have not taken into account. If so, it will be a piece of luck which goes against all past precedents.

CAPITAL ADEQUACY AMONG BANKS

During the 1970s, most banks concentrated their efforts on growth in assets, with profits a secondary consideration. Assets, and liabilities, outran capital and ratios steadily deteriorated; nobody, even the regulators, worried much while the assets were assumed to be sound.

The problems in the LDCs, as well as Drysdale, Penn Square, shipping, US oil services and agriculture (among others), made this assumption suspect. As regulatory authorities and US analysts and rating agencies focussed on capital adequacy, banks responded in part by putting assets and earnings off balance sheet; the regulators now have to worry about this, and more generally about the definition of capital and what it should cover. As well as increasing their capital some banks have increased their reserve for bad debts substantially, in many cases doubling it as a percentage of loans. This has rarely been enough to meet the change in the regulators' and rating agencies' expectations, so that many banks are as far from an acceptable level as before. And, of course, while banks in countries such as Switzerland claim to have massive reserves, and highly conservative capital ratios, they refuse to disclose the details. Nobody else really knows, therefore, either whether they are better or worse than they were a few years ago, or how good they really are.

Arguments about definitions (what is capital? adequate for what?) blend into arguments about whether it matters, or even whether too much capital is not actually damaging. Some commentators suggest that higher capital demands a higher return on assets, raising the temptation to take on lower quality assets. Others says that banks are always going to be so highly leveraged that capital of 5 per cent, 6 per cent or even 10 per cent of total assets is of secondary importance to their quality. If a well capitalised bank loses even 1 per cent of its assets in a short time, that will cut heavily enough into capital to undermine confidence, particularly as the loss usually throws doubt on the quality of the remaining assets.

The counter arguments are stronger. First, the need to earn a higher return without undue risk concentrates management's attention on profits, where it belongs. Secondly, a better capital structure can reduce the cost of funding and perhaps raise revenues, since greater confidence in the bank gives its guarantees and commitments greater value. Thirdly, attention to capital structure is part of sound bank management and more often than not goes with sound management in other areas. Fourthly - and in some ways most importantly - a strong capital structure makes it easier for banks to deal with problems in a sound way.

A well capitalised bank can afford to take larger absolute shares in particular loans, without exceeding a prudent relationship to capital, than a less well capitalised one. It can then more easily justify the resources to follow it, and if necessary work to rescue a borrower. A well capitalised bank need not panic at the thought of an early charge off. Bankers who have worked on multi-bank reschedulings will recognise the two extremes of attitudes seen. The larger, better run, better capitalised banks separate the process of deciding what to reserve or charge off from the process of trying to rescue the borrower. They may, in a bad case, provide 25 per cent, 35 per cent or even 50 per cent of the loan, and then set to work to recover the maximum amount possible and perhaps prove their original provision too conservative. If the rescue goes badly, they may increase their provision each year until, in two or three years, the book balance is zero. In each year, their profits and return on capital can absorb the loss involved without serious damage. Often they will in fact recover a large part (occasionally all) of the loan and write back the loss.

At the other extreme, poorly capitalised banks with low profits often must lend a higher proportion of their capital to be included at all. With low capital and little profit, even a relatively small absolute write off may have a serious impact on their bank's standing. These banks often react violently against any rescue proposal that does not guarantee them all their money back; they thresh around looking for a scapegoat or a deus ex machina - such as a government or a bank shareholder - whom they can blame and on whom they can lay unreasonable demands for support. All of this delays and complicates the search for a solution. It sometimes pushes the borrower over the edge of insolvency; this is usually worse for the lenders than a bank managed rescue. Often, too, it makes a provision mandatory under local banking rules. The same banks which demanded guarantees of full payment may suddenly panic at the prospect and undermine the attempts of more rational banks to negotiate the best possible deal.

Of course, these examples are extremes; few banks are as wise or as foolish - few, but some. Moreover, capital adequacy is not the only factor in deciding whether a bank reacts well or badly to problem loans.

Nevertheless, capital adequacy is important. Even the best capitalised bank can be overwhelmed, but it takes a greater and less likely catastrophe; a sound capital base gives a bank more time to look at problems calmly and deal with them effectively; and while high capital does not guarantee high profits, the best capitalised majors are also among the most profitable.

Regulators, rating agencies and the market will thus urge banks to improve capital adequacy more than cosmetically. How banks respond will help to decide how many survive without traumas or lifeboats. If enough banks recognise that a reduction in low quality, low return assets improves capital structure more cheaply and easily than raising new capital, there may even be a beneficial side effect on credit standards and margins. Unless banks so recognise, however, there can be little doubt that many banks will disappear over the next decade. The form of disappearance, and its costs, we can only guess at; that it will happen is more than a guess.

REGULATION AND DEREGULATION

A major feature in lending and capital markets over the last decade has been changes in specific regulations and in regulatory climate.

Some of the changes - the abolition of exchange control in the UK, for instance - were not directly aimed at banking at all. Others were aimed at better government management of the money supply or at relations between different parts of the financial system, rather than at specific reforms of lending. However more recently a competitive element has entered deregulation, as more countries realise that they are being left behind as financial centres.

Broadly speaking, deregulation has three aspects. It reduces the barriers between who can do what - both geographically and functionally. This opens up protected states or provinces - as in the US - to greater competition, or allows competition between commercial banks, investment banks, and non-banks in areas which had previously been the sole preserve of one of them. Secondly, it reduces barriers on what instruments can be used in given markets or currencies - CDs, short term euronotes, floating rate notes (FRNs), ECUs, etc.; thirdly, it removes or reduces barriers on foreign banks' activities in domestic markets. The US, UK, Canada, Australia, Germany, Holland, France, Italy and Spain have all moved varying distances along one or more of these paths in the ten years to 1986, although from very different starting points, and some are still moving. A different aspect of regulation relates not to which banks take what sort of risk, but to how well they do it and in particular how well they maintain their standing - prudential regulation, in other words.

While deregulation gives the customer many advantages - competition, price, innovation, to name a few - it opens up new risks to the banks and this in time tends to worry the prudential regulators. Failures, such as that of Continental Illinois, tend to make people think that perhaps deregulation is to blame (or, as with Johnson Matthey Bankers, that prudential regulation is too lax and must be tightened).

There is thus a three way battle, between:

(a) The traditional feeling of many legislators and regulators, that if it moves and looks like a bank, regulate it; and the new fashion for innovation, competition and market forces.

(b) The new fashion; and the growing recognition that it opens up new risks which most banks are not handling well.

(c) And between the pressures to tighten up so that banks cannot make mistakes for which regulators get blamed; and the recognition that bank managements are ultimately the only people who can manage banks. Regulators, at best, can only make it more likely they do it well, and limit the damage to innocent third parties if they do not.

The way in which the regulators and legislators react to these complex pressures will have a major impact on future developments in all aspects of banking, but particularly on lending. Equally, the way in which the banks handle the risks and opportunities will affect the regulators' views and reactions.

LEVERAGED BUY OUTS AND JUNK BONDS

A recurring cause of heavy losses (and sometimes of crises in individual banks or banking systems) has been concentration of lending in one field. Examples include US REITs, UK property and fringe banks, shipping, energy services, and US agriculture and of course LDCs. The decline in oil prices in early 1986 threatens to bring another, although at least this has been obvious for long enough for many banks to have taken some remedial action. Usually these concentrations arise from what is initially a sound and profitable - if often specialised - form of lending. A few banks, using care and skill, pick out sound situations and lend to them profitably. Unfortunately, other banks see the profits but fail to recognise the specialised skills or shortage of sound borrowers. They therefore pile in, driving margins down and lending to weaker borrowers as the supply of sound ones runs out. Sooner or later economic conditions change, and the weaker borrowers begin to fail. At that stage, weaker banks often aggravate the problem by panicking even about borrowers which, with careful handling, would have a good chance of survival.

The exact area and timing of one of these fashionable disasters is rarely possible to foretell; after all, if enough people foretell it, banks will not lend. However, should one of these crises hit in the next few years, on top of all the other problems banks face, it could prove to be the straw that breaks the camel's back. While no certainty exists, there are warning signs of two separate but linked phenomena that could develop into such a crisis. These are leveraged buy outs (LBOs) and junk bonds. Both are American in origin and still most prevalent there, but LBOs at least have spread to the UK and Europe and junk bonds may.

Oversimplifying grossly, an LBO involves buying a company (often a subsidiary of a larger group) with a minimal equity injection from the purchaser; the bulk of the purchase price is raised by debt to be repaid by the company being bought. (Various devices are used to get round the legal prohibitions in some countries on a company being bought with its own assets.) The result of an LBO is that the company, immediately after it, has debt substantially larger than – and often a multiple of several times – its net worth.

In a sound LBO, this high leverage is temporary, with a clear source of debt reduction to a more reasonable level. It may be a sale of surplus assets, cost cutting (perhaps due to elimination of parent company overheads), lower capital expenditure and growth, more imaginative management, or some combination of these. Operating cash flow, without any improvement, is unlikely in theory to be enough, except sometimes in management buyouts where a parent may give subsidiary management a better deal than it would give a third party. In practice, however, stock markets which are too growth oriented may undervalue cash flow; then the company may sell at a low multiple of cash flow, making the debt serviceable.

Even a sound LBO thus carries a higher risk than a normal loan. It depends on successful change, with little margin for error or ability to absorb unexpected disasters – such as sharp movements in interest or exchange rates – which are out of management's control. Since change is easier to predict than to implement, there is a real danger that the best opportunities will be quickly snapped up; leverage will then need to get higher and higher to give the equity returns needed; and banks will be drawn into taking unsound risks to obtain a modestly higher margin than they could do on a normal loan. Then a sharp downturn in the economy (or some sections of it), or a sharp upturn in interest rates may put many LBOs into trouble at once.

Junk bonds carry a similar balance of risk and advantage. An American development, the phrase describes bonds of companies which do not have an investment grade rating from the rating agencies. Originally most junk bonds were issues which started life with an investment rating and fell on hard times; more recently, they have been issued for companies with no, or a weak, rating. Again, there is no reason in principle why sound companies which have not yet reached investment grade should not issue bonds. In many cases, they need (and can use) the advantages of bonds over bank debt as much or more than a larger company. But, again, the limits beyond which the higher cost of a junk bond becomes too great need careful judgement. Finally, there is an important difference between issuing junk bonds to repay other debts (which may actually reduce the risk to banks), and issuing it to increase the total debt beyond levels which banks would accept. Indeed, it is the combination of junk bonds and LBOs which most worries many bankers and commentators. The Federal Reserve has moved to limit the issue of junk bonds in LBOs.

The point is not that either LBOs or junk bonds will certainly cause losses. Rather it is that they are good examples of the kind of fashionable opportunity which can cause banks to behave like sheep; and any such sheep like behaviour may be more than the banking system can stand on top of all its other problems.

TWO SCENARIOS

In summary, it seems unlikely that international banking can solve all its problems without losses which cause at least some banks to be taken over or otherwise supported.

An optimistic assessment would, however, see the major failures being delayed for a year or two; this would allow banks to continue to build up both equity and provisions so that they could absorb the losses when they came, or write them off against the profits of several years, not just one. An optimist could also hope that loan losses will come separately, one borrower at a time, rather than in groups, and that each will mainly affect different banks, so that the losses will be widely diffused.

An optimist could also hope that the wild scramble for innovation will slow down. This would allow banks and borrowers to concentrate on understanding the risks and advantages of the numerous new products; then they could tailor them more closely to the needs of individual borrowers, and relate the cost more closely to the risk the bank takes and the benefit the customer receives.

An optimist would believe that – whether of their own volition or under outside pressure – banks would improve their credit standards and margins. Some banks believe that margins will improve only when capital adequacy does, and in particular when the Japanese increase their level of capital. While this might come too late to affect the outcome of the next two or three years, failure in these areas would simply prolong the period of stress. Also, he would hope that the regulators would strike a happy balance between interfering and leaving the banks too free a hand.

Finally he would expect that the fall in oil prices in early 1986 would be followed by a comparable fall in interest rates and inflation and (perhaps more slowly) a rise in world wide economic growth. This would reinforce the beneficial impact of lower oil prices on companies which use it, and at least partly offset the damage done to the oil producers.

A pessimist would see immediate major loan losses in a number of areas, before the banks could complete the process of rebuilding their balance sheets; would see groups of borrowers failing and in the case of LDCs perhaps coordinating their default; would see a dramatic reversal of the disintermediation involved in securitisation, so that banks were swamped with low yielding loans just as their capital ratios (and ability to fund even sound loans) was most at risk; would see many banks, including large ones, threatened with collapse; would see a ripple effect through the interbank markets and their local equivalents, which would threaten even the strongest banks; would see governments everywhere forced to mount a massive series of rescues. If successful, these would leave banks closely regulated and almost unable to take any risks for many years – and therefore unable to provide any worthwhile services in an important area. If governments failed to rescue the banks, the consequences would be literally, indescribable.

As with most choices of extremes, actuality will probably be somewhere between these two. But banks – and regulators and customers – should not think that the pessimistic case, or something like it, cannot happen. It can, and some of the factors which will decide whether it does are out of the banks' control; to avoid it, banks will have to work strenuously and with great skill in many areas which they can control.

SUMMARY AND CONCLUSION

This book has attempted to discuss international lending by commercial banks, as they actually do it. This is harder than at the time the first edition was written. The changes are coming so thick and fast that it is not just difficult for the author to keep up with them; many banks have not yet adapted to them, and it is not yet clear exactly how they will.

The author's whole career has been with American banks, initially in New York but for the last twenty plus years in London. Inevitably this gives the book an Anglo-American flavour. It also means that the author's understanding of the London and New York markets is better than that of other markets. Nevertheless, the aim is to provide a book which is useful to all international bankers, and students of international banking, and which covers practices by banks of major countries throughout the world.

Writing about how lending is done means, among other things, recognising that different banks do it in different ways. The aim is to describe the various methods, and contrast them with methods of domestic lending, rather than to preach the 'best' way. This is partly because a descriptive book should not preach, but mainly because there is no 'best' way for all banks. Methods which suit a major American bank, with massive resources of people, information and money, would be wholly inappropriate to a private French or Italian bank. Moreover, their objectives are likely to be very different.

This does not mean that the author has no opinions, and it is probably inevitable that some of them should show. It may even be desirable that a deep concern about the lack of rigour in lending, whatever the precise method, should show clearly. Apart from that, it is hoped that the opinions are not obtrusive.

Another feature of the book is that it attempts to cover, in a relatively brief form, the whole spectrum of international lending. Inevitably, the coverage is fairly general and there are no case studies or detailed examples. (The author's subsequent three books, one with J. A., Donaldson, give more detail on specific aspects, see Bibliography.) It is hoped that the book is thus short enough, and yet advanced enough, to be of interest to busy bankers, central bankers, and corporate treasurers, and still comprehensive enough to be a useful introduction to students or trainees.

Finally, the book has failed if it has not made clear the author's fascination with international banking, problems and all. A banker – or this banker anyway – shares with the professional sportsman the opportunity to be well paid for doing what he enjoys most.

Appendix

Various ratios illustrating risk/reward features of major U S banks. *Source*: annual reports of banks concerned. Information may not be fully comparable, reflecting differences in accounting practices and/ or presentation by various banks.

Table 1 Difference between return on loans and cost of interest bearing deposits

		1972	*1973*	*1974*	*1975*	*1976*	*1977*
Bank America	Domestic	2.37	2.55	2.66	3.05	2.94	3.48
Corpn	International	2.48	1.76	1.84	2.67	2.11	2.20
	Difference	(0.11)	0.79	0.82	0.38	0.83	1.28
Bankers Trust	Domestic	1.80	1.44	1.40	1.37	1.67	2.01
New York Corpn	International	1.31	2.38	2.18	2.37	2.26	2.00
	Difference	0.49	(0.94)	(0.78)	(1.00)	(0.99)	0.01
Chase Manhattan	Domestic	3.15	1.89	1.93	2.12	2.17	2.16
Corporation	International	2.12	1.27	1.24	2.37	2.38	2.55
	Difference	1.03	0.62	0.69	(0.25)	(0.21)	(0.39)
Citicorp	Domestic	1.64	1.53	1.35	1.95	2.70	3.14
	International	3.67	3.53	4.19	4.68	4.30	4.56
	Difference	(2.03)	(2.00)	(2.84)	(2.73)	(1.60)	(1.42)
Continental	Domestic	1.22	1.16	1.36	1.68	1.71	2.13
Illinois Corpn	International	2.12	0.90	1.46	2.29	2.06	1.80
	Difference	(0.90)	0.26	(0.10)	(0.61)	(0.35)	0.33
First Chicago	Domestic	NA	1.65	1.98	1.40	1.48	1.80
Corporation	International	NA	1.31	1.91	2.70	2.25	2.26
	Difference	NA	0.34	0.07	(1.30)	(0.77)	(0.46)
Manufacturers	Domestic	2.07	1.40	1.37	2.12	2.67	3.05
Hanover Corpn	International	1.43	0.72	1.38	2.31	2.42	1.99
	Difference	0.64	0.68	(0.01)	(0.19)	0.25	1.06
J. P. Morgan	Domestic	NA	0.72	0.74	1.58	1.91	1.89
	International	NA	1.01	1.49	2.21	2.19	2.04
	Difference	NA	(0.29)	(0.75)	(0.63)	(0.28)	(0.15)
Security	Domestic	2.66	2.39	2.42	2.72	3.08	3.54
Pacific Corpn	International	1.21	0.42	0.14	1.33	1.42	1.40
	Difference	1.45	1.97	2.28	1.39	1.66	2.14

Table 2 Charge offs (i) gross, (ii) net of recoveries; as a percentage of average loans outstanding during the year[a]

		1972	*1973*	*1974*	*1975*	*1976*	*1977*
Bank America	Domestic (i)	0.34	0.44	0.45	0.76	0.58	0.38
Corpn	International (i)	0.12	0.13	0.12	0.09	0.17	0.33
	Domestic (ii)	0.26	0.38	0.35	0.69	0.47	0.20
	International (ii)	0.10	0.07	0.09	0.08	0.16	0.32
Bankers Trust	Domestic (i)	0.41	0.54	0.74	1.30	1.18	1.27
New York Corpn	International (i)	0.09	0.18	0.28	0.25	0.29	0.19
	Domestic (ii)	0.35	0.47	0.67	1.19	1.04	1.10
	International (ii)	0.08	0.18	0.28	0.25	0.25	0.14
Chase Manhattan	Domestic (i)	0.38	0.60	0.56	1.55	1.37	0.87
Corporation	International (i)	0.16	0.15	0.20	0.28	0.80	0.71
	Domestic (ii)	0.31	0.53	0.50	1.42	1.22	0.70
	International (ii)	0.14	0.13	0.18	0.24	0.75	0.66
Citicorp	Domestic (i)	0.31	0.41	0.34	1.23	1.26	1.26
	International (i)	0.19	0.29	0.44	0.65	0.76	0.53
	Domestic (ii)	0.23	0.37	0.29	1.17	1.06	1.02
	International (ii)	0.16	0.26	0.35	0.54	0.60	0.39
Continental	Domestic (i)	0.17	0.06	0.22	0.74	0.85	0.64
Illinois Corpn	International (i)[b]	0.01*	0.01*	0.09	0.27	0.14	0.14
	Domestic (ii)	0.11	(0.01)	0.19	0.69	0.78	0.51
	International (ii)	0.01*	0.01*	0.09	0.27	0.14	0.08
First Chicago	Domestic (i)	NA	0.26	0.45	1.03	1.74	1.12
Corporation	International (i)	NA	+	0.21	0.17	0.39	0.32
	Domestic (ii)	NA	0.25	0.40	0.96	1.65	1.05
	International (ii)[c]	NA	(+)	0.18	0.17	0.38	0.32
Manufacturers	Domestic (i)	0.22	0.24	0.72	0.71	0.88	0.73
Hanover Corpn	International (i)	0.03	0.01	+	0.02	+	0.01
	Domestic (ii)	0.18	0.20	0.68	0.68	0.87	0.68
	International (ii)	0.03	0.01	(+)	0.02	+	0.01
J. P. Morgan	Domestic (i)	0.12	0.02	0.35	1.01	0.67	0.50
	International (i)	0.00	0.05	0.06	0.11	0.11	0.08
	Domestic (ii)	0.09	0.00	0.32	1.00	0.66	0.43
	International (ii)	0.00	0.05	0.00	0.10	0.11	0.07
Security	Domestic (i)	NA	NA	NA	NA	NA	NA
Pacific Corpn	International (i)	NA	NA	NA	NA	NA	NA
	Domestic (ii)	0.30	0.34	0.48	0.68	0.64	0.58
	International (ii)	0.00	0.06	0.00	0.52	1.06	0.29
Unweighted	Domestic (i)	0.28	0.32	0.48	1.04	1.07	0.85
Average	International (i)	0.09	0.10	0.18	0.23	0.33	0.29
	Difference (i)	0.19	0.12	0.30	0.81	0.74	0.56
	Domestic (ii)	0.23	0.28	0.43	0.94	0.84	0.71
	International (ii)	0.07	0.09	0.13	0.24	0.38	0.25
	Difference (ii)	0.16	0.19	0.30	0.70	0.46	0.46

Notes: *a* Because of differences of presentation, some banks may include only loans from foreign offices as international, others also show some loans from head office as international. These figures should thus not be taken as precisely comparable, but rather as showing orders of magnitude.
b * Denotes actual figure not given, but less than $1 million.
c + (+) denotes charge off or recovery less than 0.01 per cent.

Table 3 Net yield on interest earning assets

		1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Bank America Corpn	Domestic	4.46	4.26	4.08	3.81	4.27	5.04	5.00
	International	2.29	2.40	1.68	2.07	1.83	1.93	2.00
	Difference	2.17	1.86	2.40	1.74	2.44	3.09	3.00
Bankers Trust New York Corpn	Domestic	4.15	4.14	3.62	3.70	3.94	3.73	2.89
	International	1.41	1.99	1.89	2.04	1.90	1.98	1.92
	Difference	2.74	2.15	1.73	1.66	2.04	1.75	0.97
Chase Manhattan Corporation	Domestic	4.82	4.98	4.85	5.18	NA	NA	NA
	International	2.24	1.89	2.20	2.31	NA	NA	NA
	Difference	2.58	3.09	2.65	2.87	NA	NA	NA
Citicorp	Domestic	4.52	4.06	3.56	4.22	4.32	3.79	4.48
	International	2.54	2.17	1.96	2.99	3.28	3.44	3.45
	Difference	1.98	1.89	1.60	1.21	1.04	0.35	1.03
Continental Illinois Corpn	Domestic	3.33	3.48	3.09	3.20	3.20	2.84	3.59
	International	1.07	1.10	1.43	1.17	1.29	0.82	1.49
	Difference	2.26	2.38	1.66	2.03	1.91	2.02	2.10
First Chicago Corporation	Domestic	NA	NA	NA	NA	NA	NA	NA
	International	NA	NA	NA	NA	NA	NA	NA
	Difference	NA	NA	NA	NA	NA	NA	NA
Manufacturers Hanover Corpn	Domestic	2.17	1.68	1.06	NA	NA	2.63	2.78
	International	1.52	1.37	1.11	NA	NA	1.45	1.76
	Difference	0.65	0.31	(0.05)	NA	NA	1.18	1.02
J. P. Morgan	Domestic	4.85	4.57	4.38	4.43	5.04	4.96	4.95
	International	1.19	1.34	1.15	1.61	1.75	1.55	1.89
	Difference	3.66	3.23	3.23	2.82	3.29	3.41	3.06
Security Pacific Corpn	Domestic	4.72	4.42	4.18	4.39	4.74	4.75	4.60
	International	2.25	1.98	2.63	2.29	2.54	2.25	2.61
	Difference	2.47	2.44	1.55	2.10	2.20	2.50	1.99

Note: The figures in Table 3 and 4 may not be comparable to those in Tables 1 and 2, due to changes in presentation of figures in the banks' annual reports over the period.

Table 4 Charge offs (i) gross, (ii) net of recoveries; as a percentage of average loans outstanding during the year

		1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Bank America	Domestic (i)	NA	NA	NA	NA	NA	NA	NA
Corpn	International (i)	NA	NA	NA	NA	NA	NA	NA
	Domestic (ii)	NA	0.43	0.48	0.54	0.93	1.08	1.50
	International (ii)	NA	0.17	0.23	0.45	0.86	1.13	2.84
Bankers Trust	Domestic (i)	0.52	0.89	0.75	0.85	0.36	1.16	0.56
New York	International (i)	0.08	0.05	0.06	0.17	0.33	0.29	0.69
Corporation	Domestic (ii)	0.27	0.66	0.41	0.73	0.18	0.86	0.31
	International (ii)	0.02	0.04	0.04	0.16	0.23	0.26	0.65
Chase	Domestic (i)	0.54	0.84	0.70	1.07	NA	NA	NA
Manhattan	International (i)	0.24	0.15	0.10	0.33	NA	NA	NA
Corporation	Domestic (ii)	0.33	0.66	0.56	0.77	NA	NA	NA
	International (ii)	0.19	0.09	0.06	0.24	NA	NA	NA
Citicorp	Domestic (i)	1.08	1.07	0.87	0.85	0.79	0.86	1.26
	International (i)	0.28	0.23	0.32	0.48	0.53	0.48	0.84
	Domestic (ii)	0.73	0.79	0.56	0.61	0.57	0.64	1.01
	International (ii)	0.07	0.12	0.21	0.36	0.44	0.38	0.73
Continental	Domestic (i)	0.37	0.43	0.42	1.70	1.57	3.60	0.60
Illinois Corpn	International (i)	0.24	0.01	0.09	0.14	0.93	1.55	1.11
	Domestic (ii)	0.25	0.38	0.31	1.60	1.37	3.41	0.23
	International (ii)	0.23	P	0.09	0.14	0.92	1.51	0.95
First Chicago	Domestic (i)	1.08	0.95	0.70	0.86	0.96	2.05	1.23
Corporation	International (i)	0.08	0.38	0.22	0.13	0.34	1.38	1.26
	Domestic (ii)	0.83	0.77	0.44	0.71	0.80	1.94	1.06
	International (ii)	P	0.36	0.18	0.10	0.32	1.32	1.11
Manufacturers	Domestic (i)	0.48	0.64	0.51	0.53	0.65	0.82	1.13
Hanover	International (i)	0.10	0.03	0.06	0.14	0.24	0.26	0.45
Corporation	Domestic (ii)	0.39	0.42	0.41	0.41	0.46	0.66	0.97
	International (ii)	0.10	0.02	0.06	0.13	0.23	0.24	0.44
J. P. Morgan	Domestic (i)	0.02	0.20	0.04	0.45	0.29	0.09	0.37
	International (i)	0.00	0.01	0.04	0.14	0.42	0.28	0.48
	Domestic (ii)	P	0.18	P	0.33	0.13	P	0.24
	International (ii)	0.00	0.01	0.03	0.14	0.42	0.24	0.42
Security	Domestic (i)	NA	NA	NA	NA	NA	NA	NA
Pacific Corpn	International (i)	NA	NA	NA	NA	NA	NA	NA
	Domestic (ii)	0.34	0.40	0.32	0.52	0.55	0.85	1.27
	International (ii)	P	0.49	P	0.02	0.07	0.35	0.32

Glossary

Acceptance. The signature of the drawee on the face of a bill of exchange, accepting the obligation to pay at maturity. Alternatively, a bill of exchange which has been accepted.
Amortisation. The payment of a loan in instalments.
Average Life. The weighted average period for which a loan is outstanding, taking into account the amortisation schedule. Two loans with the same final maturity will thus have different average lives if one amortises earlier and/or more frequently than the other.
BBAIRS or BBAIRS Agreement: British Bankers Association Interest Rate Swap. A standard agreement, drafted under the auspices of the BBA, for use in interest rate swap deals. Designed to avoid disputes about the terms of deals done on the telephone by dealers who are not really interested in documentation; and to prevent deals done in good faith from being repudiated, whether or not in good faith, because of disagreements about terms. Initially intended only for interbank deals of less than two years, it has become used for a wider range of maturities and counterparties.
Best Efforts Syndication. A syndicated loan where the amount is not underwritten in advance and the borrower obtains the full amount (or sometimes anything) only if syndication is successful. *See also* Underwritten loan.
Big Bang. 27 October 1986, the date on which the London Stock Exchange abolished minimum commissions, and introduced a wide range of consequent reforms which changed the whole of the securities business in London. Sometimes used to refer to the date, sometimes to the package of reforms, sometimes to the wider range of changes happening in London securities markets concurrently. Some of these result from the Financial Services Act, which will come into force during 1987, others from changes in the euromarkets. Overall they add up to one of the most farreaching periods of change in any market.
CD or Certificate of Deposit. A certificate, in negotiable form, issued by banks; CDs certify to the amount deposited, the maturity and the rate of interest. They are printed on secure paper and there is an active market in them in both New York and London. Although their

status as a negotiable instrument has never been tested in an English court, lawyers are satisfied that the custom of the market to treat them as such is well established and would be upheld if challenged.

Competition and Credit Control. The name of a Bank of England regulation introduced in the early 1970s. It marked the first attempt to eliminate the clearing bank cartel and open up the commercial bank market to competition. Although not wholly successful, and blamed by some for the fringe bank crisis in the mid-1970s, it (arguably) marks the beginning of deregulation in the City.

Condition Precedent. A condition in a loan agreement which must be met before the first borrowing.

Country Risk. The risk arising from political, economic, legal or social factors in a particular country. The concept covers the risk of lending to or under the guarantee of a government. It also recognises that companies incorporated or having their main assets or earnings in the country are subject to these factors and can be prevented from meeting their debts by them. *See* Chapter 3 *and* Exposure and country exposure.

Covenant. A clause in a loan agreement in which the borrower 'convenants' that he will do or procure (or refrain from doing) certain things - such as granting security. Financial covenants (also sometimes referred to as ratio covenants) involve maintaining agreed financial ratios on items such as working capital, debt to worth or interest cover.

Cross Border Support. A guarantee, keepwell or other form of support issued by a company in one country covering borrowing in another country.

Cross Default. Where a default in any other loan agreement is an automatic default in your agreement, this is known as a cross-default. *See* Default *and* Chapter 7.

Debtors. Amounts due to a company from its customers for goods or services supplied. Often also referred to as trade debtors or (in American terminology) receivables.

Default. Failure by a borrower to pay principle or interest when due; or by a borrower, guarantor or other party to the contract to meet any other condition of the agreement, where such failure is defined in the agreement as an event of default.

Drawdown. The initial borrowing, or drawing, under a facility.

ECU or European Currency Unit. A basket of currencies from countries in the EEC. Originally used to settle transactions in the European Monetary System between governments, it has developed a life in the private sector. It is now used in bank borrowing and securities issues.

Edge Act. This was intended to allow US banks to undertake certain activities overseas or at home if they were solely international, and which they were forbidden domestically. Although not much used initially, in the 1960s and 1970s it enabled US banks to move into areas such as investment banking through overseas subsidiaries and to establish subsidiaries in the US outside their home states.

Eurocurrency. In one sense any currency held in a bank outside the currency's country of origin. In a broader sense, eurocurrencies are those in which there is an active market outside their country of origin.

Eurodollar Disaster Clause. A clause in loan agreements designed to protect lending banks from changes in the euromarket which either make it impossible to obtain funds, or drastically change the cost of obtaining funds. *See* Chapter 7.

Exposure and Country Exposure. The maximum amount a bank could lose if all its facilities to one borrower, or classified as country risk for one country, were fully utilised when the borrower or country failed. This assumes a nil recovery.

FRN or Floating Rate Note. A security with all the characteristics of a normal bond, except that its rate of interest is reset periodically, instead of being fixed throughout its life. The rate is linked to a market indicator; in the euromarkets this is normally LIBOR. The rate is reset at stated intervals, most commonly six months, but occasionally less. There are also more elaborate variants; in some cases, for instance, the LIBOR rate may be six months but it may be reset every month instead of every six months.

Fixed Rate Lending. Lending for a fixed period at a fixed agreed rate, rather than at a rate fluctuating in line with a proxy for cost of money. Usually used in reference to medium term lending.

Gearing. The extent to which a company is financed by debt rather than equity. (Leverage in American terminology.)

Going Concern Analysis. The analysis of a company on the assumption that it will continue to operate for the foreseeable future. It contrasts with liquidation, or gone concern, analysis, which looks only at the amount the assets would realise in liquidation. Going concern analysis is interested in the company's ability to generate cash flow to meet its obligations, and is therefore sometimes called cash flow analysis.

Herstatt Crisis. The cause of the crisis was a German bank (Herstatt) which failed in the middle of the day, and cost a number of major banks large losses when it failed to make dollar payments after receiving the Deutschemark equivalent in settlement of foreign exchange transactions. This focused the market's attention on the risk inherent in settling different parts of a transaction on opposite sides of the Atlantic, due to the time difference; and on the risk of further bank failures. Since international banking involves many large transatlantic settlements, these two risks reinforced each other, and made it difficult for many banks to obtain funds. Some could not obtain them at all, others only a substantial margin above the normal rate.

Inventory. *See* Stocks.

Junk Bond. A bond which does not carry an investment grade rating from the leading US rating agencies. Originally this meant that the issuer was a company which had declined and lost its earlier good rating. More recently, however, there has been a surge of issues from companies that have never been investment grade, or which are using the junk bond to finance an acquisition on terms which cause loss of the rating. Naturally, such bonds carry a higher interest rate, often much higher, than investment grade; they also carry a higher risk.

Keepwell. One of a number of forms of support supplied by a parent company to persuade a bank to lend to the subsidiary. Weaker than a guarantee and often not legally binding. Many other names are used in different countries.

LBO or Leveraged Buy Out. The purchase of a company, financed by debt which the borrowers expect to repay from earnings or assets of the company purchased. As a result the purchased company is normally highly leveraged (or geared in English terminology); hence the name.

LIBO or LIBOR. London Interbank Offered Rate, the rate at which deposits of a given currency and maturity are offered in the London market by, or to, prime banks. Represents the notional cost of money in many loans, to which the margin or spread is added to obtain the total interest rate.

Liquidator and Liquidation. The official responsible for, and the process of, collecting the assets and dividing the proceeds among the creditors of an insolvent or bankrupt company. While each country has a different name for the process, this English terminology is used in this book.

Liquidity. The relationship between cash and assets which quickly turn into cash, and liabilities requiring imminent payment. Put another way, a measure of a borrower's ability to meet short-term liabilities as they fall due. It contrasts with solvency, which refers to the ability to meet all obligations eventually, but pays less attention to the timing of payment.
Margin. The difference between the cost of money to the lending bank (or a proxy such as LIBO) and the rate at which the bank lends to the borrower. This represents the notional net interest earnings to the bank, from which to defray operating costs, absorb bad debts and provide a return on capital. Often also referred to as the spread.
Merchant Bank. In its original meaning, those British banks whose origin was a merchant, but who now act mainly as investment banks. More generally, any bank lacking the deposit base to act mainly as a lender, and/or active in a variety of investment banking fields.
MOF or Multi Option Facility. A facility similar in most ways to a NIF or RUF (*see other entries*). Main difference is that instead of allowing only bids for notes it allows the choice of several instruments. Each MOF is different in the choice of instruments it allows; a fairly typical selection might include notes related to LIBOR and to the US CD rate, or sterling or dollar acceptances, as well as a choice of currencies.
Moratorium. A temporary waiver of amortisation on a loan, to enable the borrower to cope more easily with a cash shortage. Interest payments may continue or may also be deferred.
NIF or Note Issuance Facility. A facility under which the borrower/issuer can ask banks, usually in a tender panel, to bid for notes it issues with a maximum margin over the agreed marker rate, such as LIBOR, If banks fail to bid for all the notes the borrower wishes to issue, a group of 'underwriting banks' commit to lend at an agreed margin over, usually, the same marker. This gives the borrower the certainty that it can get its money at a maximum cost, and the flexibility to try to better that cost.
Overdraft. A debit balance on a current account. A recognised and popular means of borrowing in many countries, but illegal or frowned upon in most circumstances in the US.
Praecipium or Praesipium. A share of the management fee taken off the top by the lead manager.

Prime rate. The published rate at which US banks lend short term money to their strongest commercial customers; most other rates are linked to it. More generally, the best rate or margin a bank charges its customers.
Project Finance. Specifically finance of a project, repayment which is expected to come wholly or largely from the project. In relation to country lending, finance provided for a specific project, even if repayment does not depend on the project, rather than for balance of payment or other general use.
REIT or Real Estate Investmnet Trust. An American method of allowing the small investor access to a diversified portfolio of real estate. The trust issues shares and uses the proceeds to invest in real estate. The REITs must meet certain standards to qualify for tax relief. They were popular in the early 1970s, until their managers tried to improve on their capital performance by borrowing. The period 1972–4 was one of high interest rates and low growth in rentals. At the same time property values declined and many REITS were unable to pay their debts. Almost all had some degree of difficulty and many banks lost large sums as a result.
Recapture Clause. A clause obliging the borrower to repay the loan more rapidly if (usually) earnings or cash flow are above agreed levels; occasionally the recapture may relate to commodity prices, rental or charter income etc.
Receivables. *See* Debtors.
Rescheduling. A rearrangement of amortisation and/or extension of the maturity of a loan caused by the borrower's inability to meet the original repayment schedule.
Risk/Reward Ratio. Banks are in business to take risks, but also to minimise the risks by the quality of their understanding and analysis. Taking risks is a service for which banks expect to be paid. The payment should be proportionate to the size and nature of the risk, or banks will in the end lose more money from bad risks than they make from interest or other payment on the successful. Risk/reward ratio is not a ratio in the literal sense, but a shorthand for the balance between the risk and the payment.
RUF or Revolving Underwriting Facility. A facility similar to a NIF, except that the notes are sold on the borrower's behalf by a dealer. He seeks bids from the market, and passes these on to the borrower,

rather than tender panel banks bidding in their own name but then selling the notes into the market.
Securitisation. The process whereby traditional bank borrowing is replaced by the issue of various forms of security, and the wide repercussions on the banking industry which result from it.
Sell down. The process of syndicating an underwritten loan to reduce the managers' share to the amount they wish to keep.
Stocks. Raw materials, components, work in process and finished but unsold goods. In American terminology, inventory.
Sovereign Risk. A broader version of country risk, sovereign risk recognises that companies can be affected by adverse developments in many countries, not just their home country. *See* Country Risk *and* Chapter 3.
Spread. *See* Margin.
Subrogation. The taking over of the rights of a creditor in return for paying the obligation due to that creditor - in other words the payer stands in the payee's shoes.
TLC or Transferable Loan Certificate. An instrument included in some syndicated bank loans in an attempt to make them saleable and so competitive with securitised forms of lending. It has never really been successful.
TP or Tender Panel. A group of banks who agree to bid for notes or other instruments issued under the terms of a NIF, MOF or similar facility.
Tranche. Where a loan is drawn down in separate amounts, with different interest periods and perhaps maturities, each amount is a tranche.
Transfer Pricing. The sale of goods or services by a company to another in the same group at a price set by the group, not by the market. Can be used to move profits or cash from one company to another.
Turnover—Debtors or Stocks. The measurement of the rate at which debtors turn into cash, or stocks into debtors. Can be described in number of days, or times per year (i.e., if debtors turn over in 91 days, they also turn over four times per annum).
Underwritten Loan. A syndicated loan in which one or more managers undertake to provide the borrower with a specific amount, which is more than they really wish to lend, and then syndicate (sell down) the portion they do not want. *See also* Best efforts syndication.

Upstream Guarantee. A guarantee by a subsidiary of amounts owing by its parent.
Upstreaming. The excessive withdrawal of cash from a subsidiary for the benefit of the parent, by means of loans, royalties, management fees, dividends, leading and lagging or otherwise.

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Index