Controlling Credit Risk

The Credit Memorandum (or Credit Memo)

1. Internal document needed to approve or renew a loan
   - Presented to a commitments committee or a loan committee
2. Tells the entire story of the loan
3. Aids in monitoring a loan after loan is made
4. Brings parties back to the table when covenants or pledges are broken
5. Satisfies regulatory requirements (bank examiners)

Components of the Credit Memo

- The term sheet
- Exposure summary
- The story behind the credit
  - Relationship or, how did we get here?
  - Business and financial analysis (SWOT)
  - Debt capacity and repayment sensitivities
  - Exceptions
  - Mitigating factors
  - Loan risk rating

Term Sheet Describes Structure of the Loan

Who?	What?	Why?	How?
The borrower and any subsidiaries	Facility(ies) description, e.g, the type of loan	Use of proceeds	Ranking, Security, Pricing, Prepayment, Covenants, Conditions, Guarantors

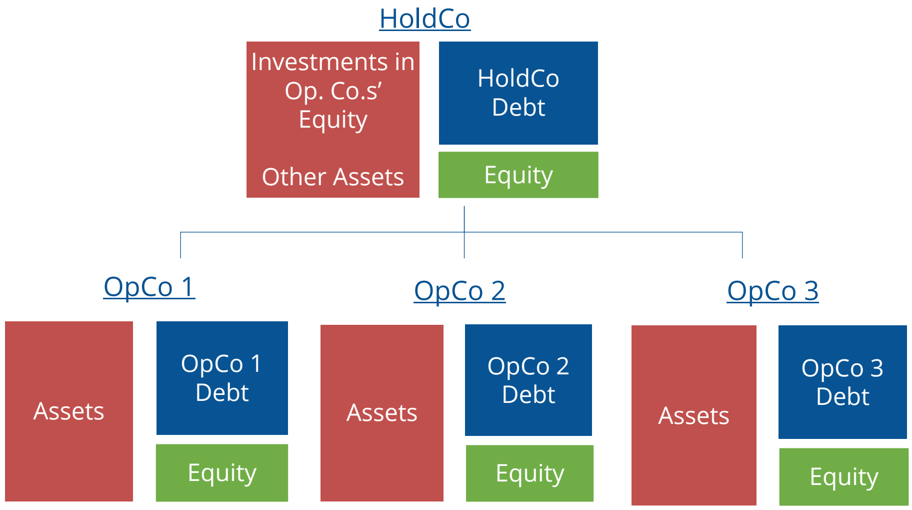
To Whom are we Lending?

Issuer versus issue ratings.
The complexities of a group structure is one of the reasons why an issuer (umbrella rating) can only measure the probability of default, and not the likelihood of loss. The rating of individual securities measure the probability of both default and loss.

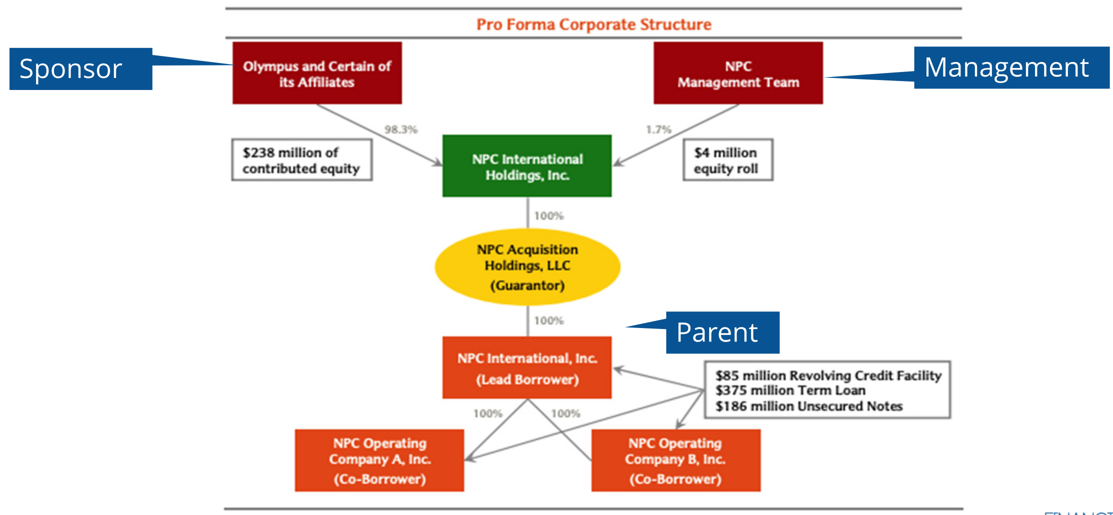
Loans between the holding company and subsidiaries.
Banks tend to want to be closest to the entity that generates cash flow or holds the assets. In a liquidation, the subsidiaries are generally liquidated first and proceeds distributed upwards.

Guarantees.
There are frequently guarantees between the subsidiaries and the holding company – or finance company. These may be on the basis of joint and several liability or specific guarantees between holding companies. These have the effect of circumventing structural subordination by the group structure.

And Where in the Capital Structure?



A Straightforward Structuring



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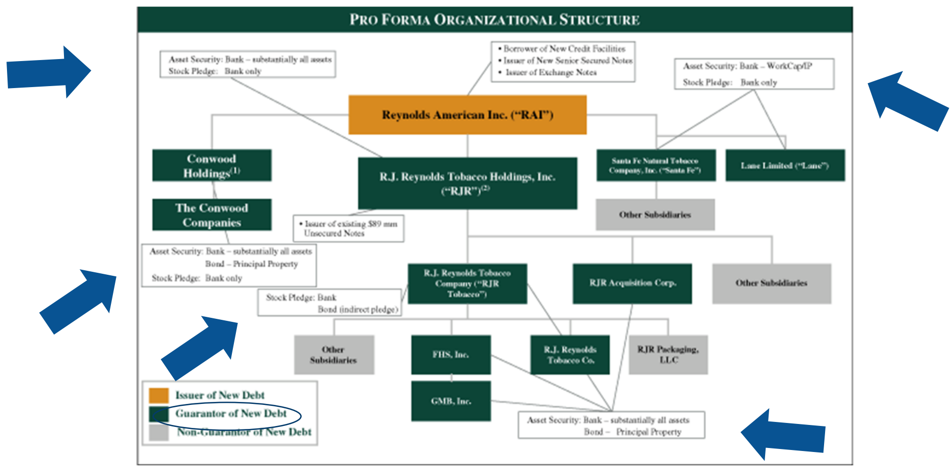
A Complex Structuring



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What Type of Loan Are We Making

What type of debt is needed?

Short term debt	vs	Long term debt
Revolver Swingline		Amortizing A Term (TlA) Institutional (B-, C-, D-Term) Second lien Covenant lite Bridge loans
Supports business seasonality by enabling an increase in assets on a temporary basis. Repayment possible once those assets have converted into cash.		Repayment provided by the conversion of net profit into cash flow over a longer period of time. Used for financing longer term operating assets such as PPE or acquisitions.

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How will the Funds be Used?

Increase level of current and/or LT assets	Pay an extraordinary liability	Return value to shareholders	Replace cash depleted by operating losses	Refinance an existing loan
• Inventory • Capex • M&A	• Lawsuit	• Dividend • Share repurchase		• Recaps • LBOs

Banks want to know precisely how the proceeds will be used

Which options represent the best credit risk for the bank?

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Paying for the Loan: Pricing

	Investment grade	Sub-investment grade/Middle Market
Types of borrowing:	1- to 5- year revolving credit facilities; Notes (bonds)	1- to 5- year revolving credit facilities; Term Loans; Notes (bonds); Mezzanine
Benchmark:	Prime (occasionally called Base Rate) LIBOR (bonds, revolvers) 1- to 5- year CDS for drawn amounts or revolver	LIBOR
Spread:	Based on credit rating, notching	Based on pricing grid according to ratios

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Example of Leveraged Loan Pricing Grid

Facilities	• $1,000 million Revolving Credit Facility • $750 million Term Loan A • $500 million U.S. Term Loan B
Maturity	• Revolver and Term Loan A: December 15, 2022 • Term Loan B: December 15, 2024[1]
Pricing	• Revolver and Term Loan A[2]: (see grid below) • US Term Loan B: LIBOR + 175 bps, 0% floor

Total Leverage	LIBOR +	Commitment Fee
< 2.25x	100 bps	25 bps
>= 2.25x	125 bps	25 bps
>= 3.00x	150 bps	30 bps
>= 4.00x	175 bps	30 bps
>= 4.50x	200 bps	40 bps

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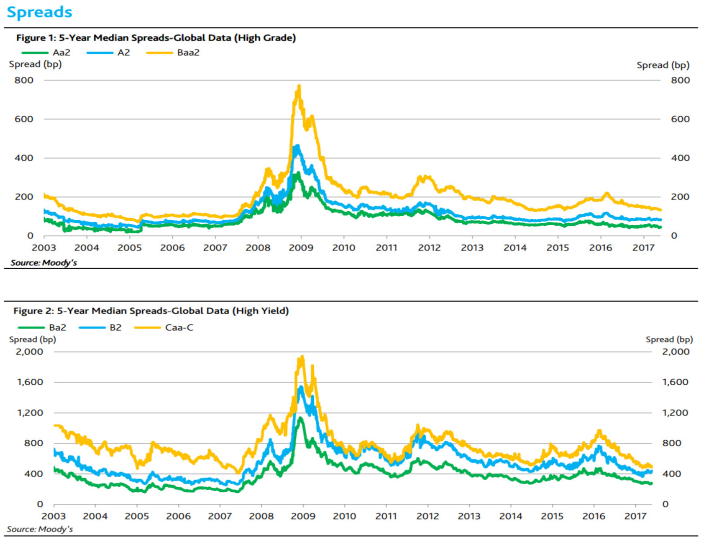
Debt Pricing Spreads



Adding on the Fees

Upfront fee	Paid by the issuer at the close of the deal (100 to 500 bps). The lead arranger or co-arrangers receive a larger amount for structuring and underwriting. The fees are tiered to encourage lenders to commit to higher levels.
Commitment fee	Paid to lenders on undrawn amounts of a revolver or prior to drawing a term loan.
Facility fee	Paid on facility's entire amount, regardless of what has been drawn.
Usage Fee	Paid when revolver is drawn above a set level
Prepayment fee	Typically only applies to institutional term loans. Usually about 2% in year 1 and 1% in year 2
Administrative agent fee	Annual fee paid to distribute interest/principal payments, maintain lender lists. A collateral monitoring fee is part of this for secured loans
LOC fee	A guarantee that the lenders will make funds available for corporate activities

Protecting the Loan: Seniority

Super Senior secured debt holders (revolver)

Senior secured debt holders

Senior unsecured debt holders

Subordinated debt

Junior debt

Legal / contractual ranking of creditors debt holders is defined by the legal documentation and determined by the law

Pari passu

All debt holders within the same creditor class are treated equally (repaid at the same time and proportionately the same). In some countries, fixed charge creditors (banks) have preference over floating (trade creditors).

The lower the ranking the higher loss-given-default %

Protecting the Loan: Security, Guarantees and Collateral

Security

All tangible and intangible assets. Can be specific assets to back specific loans. Loans can also be backed by stock of OpCos in leveraged deals

Ranking / loss given default (LGD)

Inter-creditor agreements

Inter-creditor agreements establish ranking amongst creditors and determine their ability to take action against company and their relationship between each other

Guarantees

Guarantees can be used to improve a position of creditor within a structure, but the guarantee needs to be enforceable

Monitoring the Loan: Covenants

Covenants
Breach of a covenant constitutes default hence it gives a lender a right to act. Since debt holders have no voting rights, covenants serve as a mechanism of representation of debt holders interests via:

- Protecting sources of cash for debt repayments
- Limiting management's ability to use cash
- Quantify debt related financial soundness matters

Covenants serve as early warning signs in case of company's performance deterioration

Default

Default indicates an obligation has not been met in a timely manner / loan agreement has been breached

Right to Act for Lenders

In case of default the lender can
- Accelerate the debt
- Renegotiate terms
  - Changes in financial terms
  - Operational & management changes
  - Debt to equity swap
- Waive the breach

Types of Covenants

Financial Covenants
Minimum level of cash flows
Maximum level of debt / EBITDA
Minimum level of interest cover
Minimum liquidity

Negative covenants
Negative pledge
Restrictions on dividends
Restrictions on selling assets
Restrictions on M&A

Affirmative covenants
Financial reporting compliance
Compliance with regulations/environmental laws
Maintenance of authorizations / approvals
Maintenance of insurance
Paying taxes

Change of control
In case the borrowing entity gets acquired by a weaker credit entity, the borrowings could be repaid or interest stepped up

Cross acceleration
If the borrower has breached the terms of one agreement and one lender has a right to accelerate, another lender under another agreement can accelerate as well (common in high yield, investment grade bonds)

Cross default
If a borrow defaults on one debt tranche, another debt tranche will be automatically in default

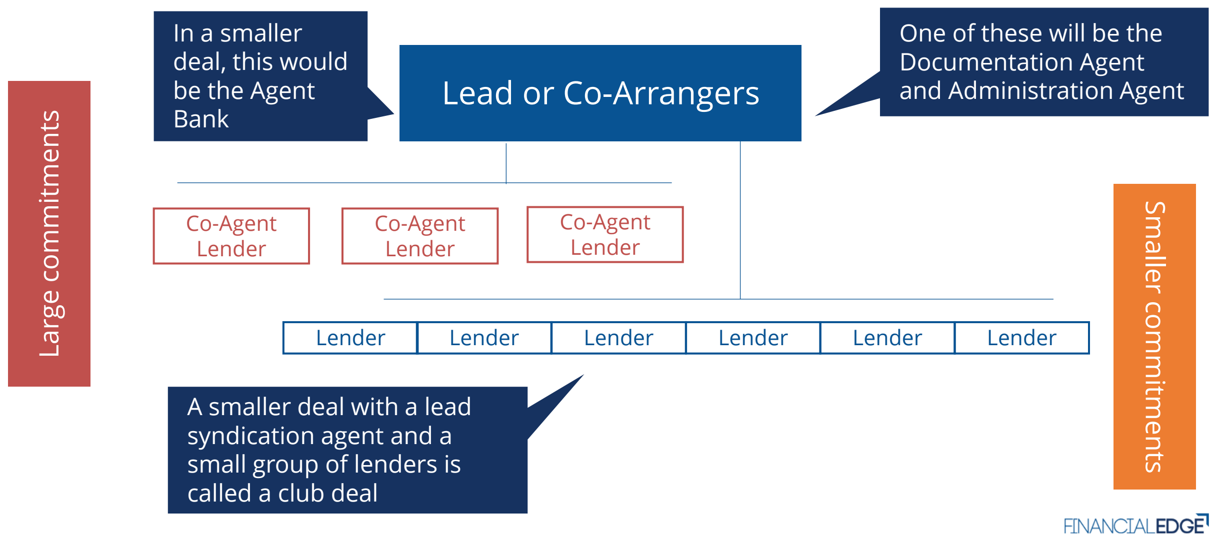
Financial Covenants

Leverage	Coverage	Liquidity
Total debt/Capital	EBIT/Interest	Current assets/current liabilities
Total debt/EBITDA	(EBITDA-capex)/Interest	Current assets-inventories/current liabilities
Total debt/Operating Cash Flow	EBIT/debt service	
(Can be applied to senior debt or net debt)		

Other common financial covenants:

- Tangible net worth
- Maximum capex

Loan Syndication



Primary Market Loan Investors

Primary Loan Market

Banks
- Receive fees and interest relative to risk
- Reluctant to allocate capital on yield alone. Usually require a relationship

Finance Companies
- Borrow to fund loans
- Usually participate in smaller deals
- Prefer asset-backed loans with wide spreads

Institutional Investors
- Spread relative to credit quality are main drivers
- Liquidity and market technical (supply and demand)
- The higher the liquidity the thinner the spreads
- Mutual/prime fund
- Privately managed credit fund
- CLOs (collateralized loan obligations)

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Collateralized Loan Obligations (CLOs)

Corporate Capital Structure
- **Senior Secured Loans**
- Subordinated /Unsecured Debt
- Equity

CLO Capital Structure
- AAA debt tranche
- AA debt tranche
- A debt tranche
- BBB debt tranche
- BB debt tranche

Higher claim on cash flows, last loss of principal

Lower claim on cash flow, first loss of principal

Equity Tranche ← Excess payments

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Secondary Market Loan Investors

Assignments

- Assignee becomes direct signatory to the loan and receives interest /principal directly from admin agent
- Typically have consent of the borrower
- Assignment fee waivers are a way to bring trades to the arranger’s desks
- Primary assignments are usually for CLOs and hedge funds who cannot buy loans in primary market due to tax consequences

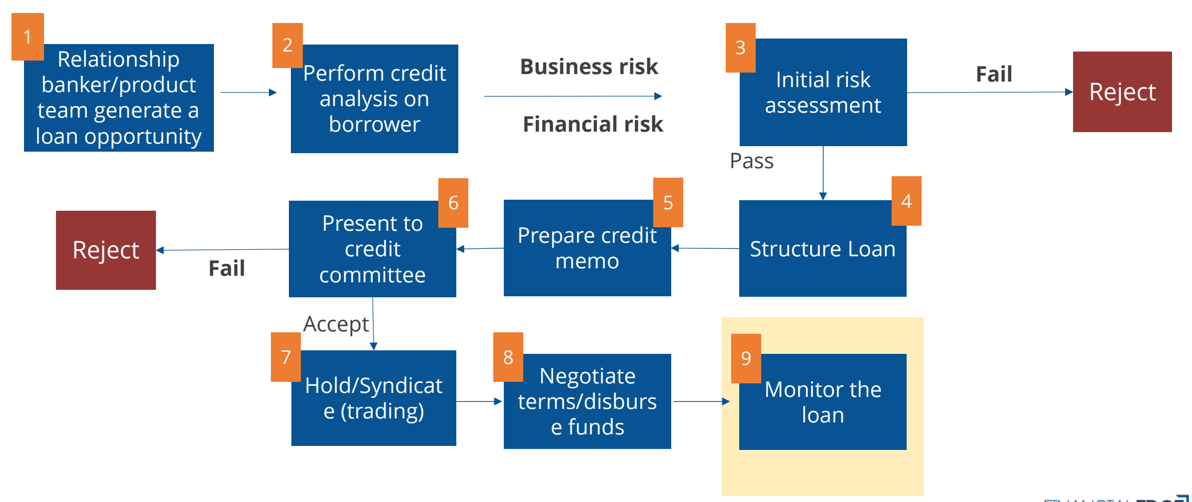
Participations

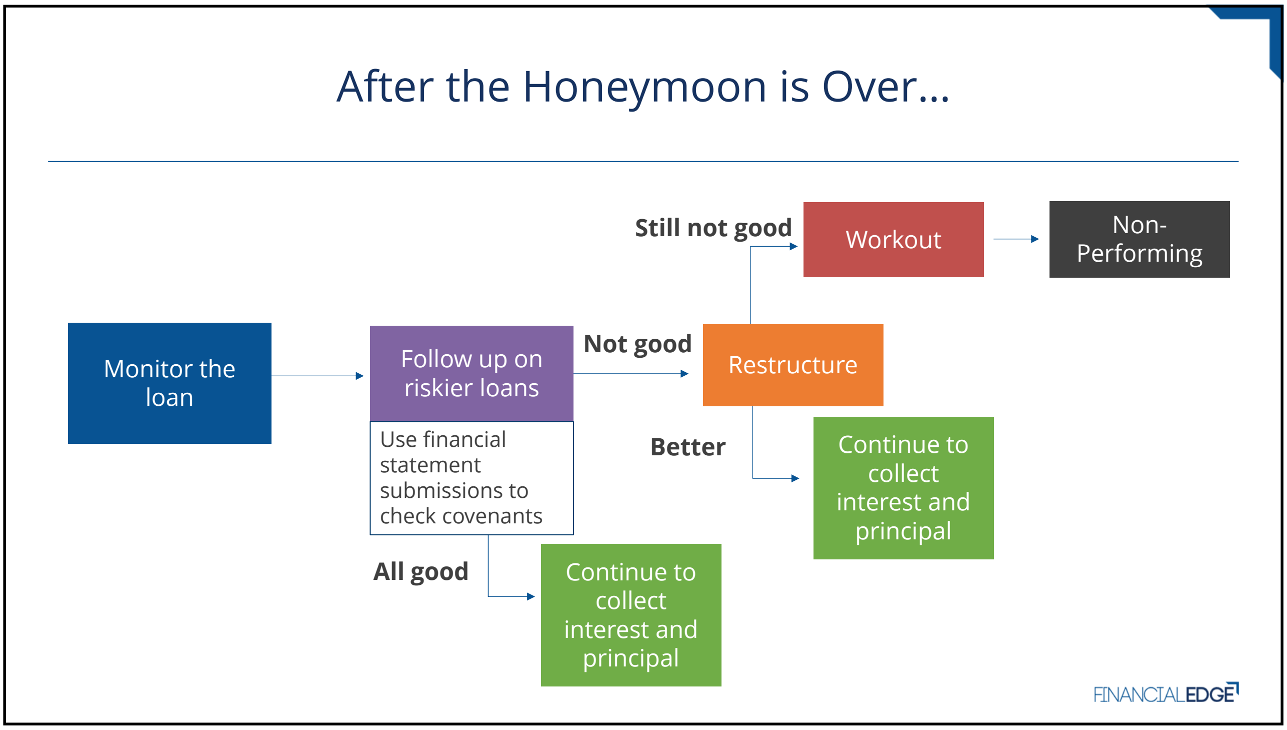
- Lender is still official holder of loan
- Participant does not have direct claims against borrower if default occurs

Loan spreads hard to calculate as they can be prepaid at anytime without penalty

- Traders use a yield to a theoretical call with a 3-or 4-year average life

The Process of Making a Loan




After the Honeymoon is Over…
Monitor the loan
Follow up on riskier loans
Use financial statement submissions to check covenants
All good
Continue to collect interest and principal
Not good
Restructure
Better
Continue to collect interest and principal
Still not good
Workout
Non-Performing
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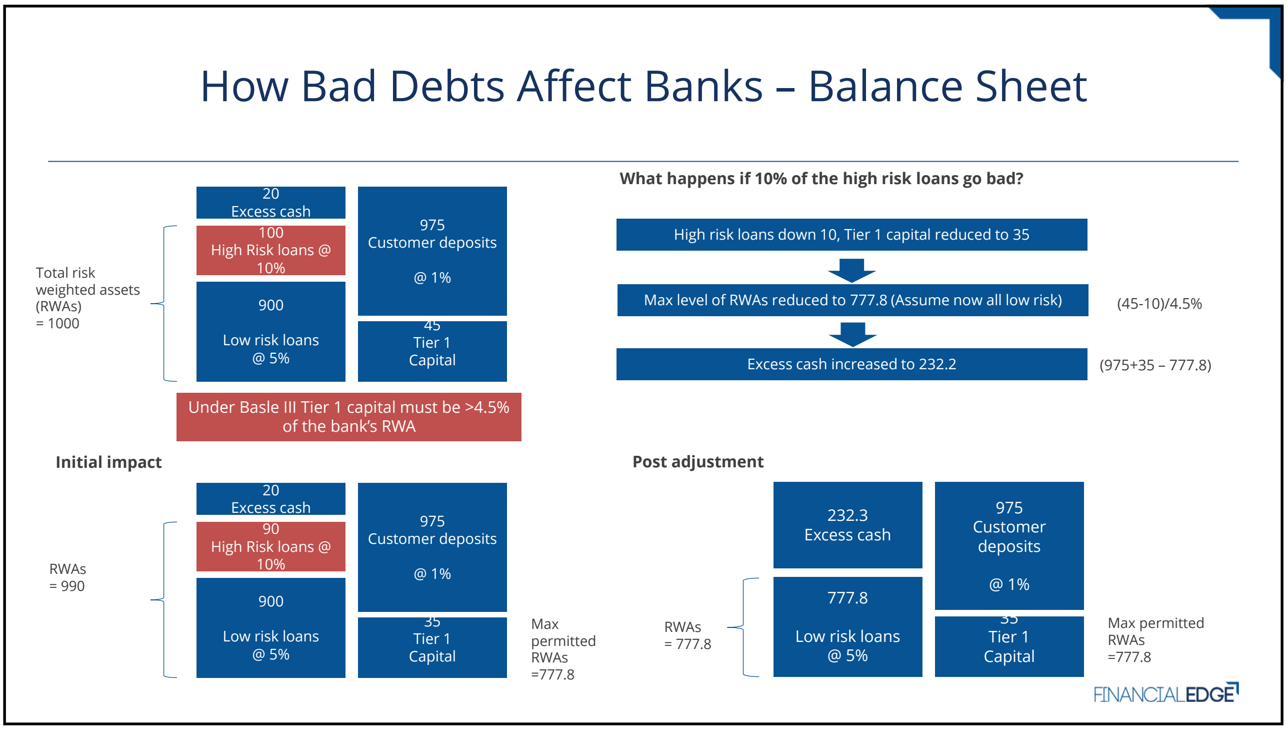
How Bad Debts Affect Banks – Balance Sheet
20 Excess cash
100 High Risk loans @ 10%
900 Low risk loans @ 5%
975 Customer deposits @ 1%
45 Tier 1 Capital
Total risk weighted assets (RWAs) = 1000
Under Basle III Tier 1 capital must be >4.5% of the bank's RWA
What happens if 10% of the high risk loans go bad?
High risk loans down 10, Tier 1 capital reduced to 35
Max level of RWAs reduced to 777.8 (Assume now all low risk)
(45-10)/4.5%
Excess cash increased to 232.2
(975+35 – 777.8)
Initial impact
20 Excess cash
90 High Risk loans @ 10%
900 Low risk loans @ 5%
975 Customer deposits @ 1%
35 Tier 1 Capital
RWAs = 990
Max permitted RWAs =777.8
Post adjustment
232.3 Excess cash
777.8 Low risk loans @ 5%
975 Customer deposits @ 1%
35 Tier 1 Capital
RWAs = 777.8
Max permitted RWAs =777.8
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Non-performing Assets

Borrower

Will often ask the bank for more time or money (both of which are now very expensive as the risk to bank has gone way up)

Workout Specialist

Not a relationship manager/client banker

Chief responsibility is to protect the bank's balance sheet

Regulators

Put pressure on banks to identify early loans that might end in loss

BANK

Bank can no longer recognize interest revenue as all payment from borrow go to reducing capital

Loan moves to highest risk spectrum requiring more capital and attention which is more expensive to bank

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