
The London Approach: distressed debt trading

In a speech at the Euroforum Conference on 23 March, Mr Pen Kent, an Executive Director of the Bank of England, considered how the London Approach to company workouts could best be reconciled with the developing secondary market in distressed company debt. He announced that the idea of having a moratorium on trading, to avoid disruption at sensitive times, had been rejected by the banking community. And he set out a number of recommendations on conduct to allow the spirit of the London Approach to be extended to cover trading in distressed debt.

I have been asked to speak about ‘harmonising the needs of all parties’: that suits my purpose very well, because it is an area in which I hope to show considerable progress has been made. Indeed, I had not fully appreciated how much progress until I attended a meeting at British Bankers’ Association last Friday.

I will briefly explain what the ‘London Approach’ actually is, the range of issues we have been looking at recently and then specifically how the needs of the various parties interested in the distressed debt market might be reconciled.

The London Approach

The *main aim* of the London Approach is: to maximise value for creditors. The aim is not to prevent receivership or administration if this is shown to be the most appropriate outcome, but to avoid the unnecessary collapse of potentially viable businesses as a result of disagreements between creditors. In practice, London Approach restructurings tend to be organised by banks who have the resources and experience to formulate ‘workout’ proposals. The hope is that where insolvency is avoided this will also serve the interests of other stakeholders, including trade creditors, shareholders, employees etc.

The *main tenets* of the London Approach are:

- Banks are initially supportive and don’t rush to appoint receivers.
- Decisions about a company’s future are made on the basis of reliable information which is shared among all the parties to a workout.
- Banks and, where appropriate, other creditors work together to reach a collective view on whether and how a company should be given financial support.
- Pain is shared on an equitable basis.

These are ‘common-sense’ principles which, together with a number of more detailed ‘conventions’—eg super-priority being accorded to new money—have been developed within the banking community to serve their financial and ‘reputational’ interests. The London Approach is voluntary

and it is widely used, because it is seen to work and to be fair.

Role of the Bank of England

Our role is part missionary and part peacemaker. As *missionary*, we advocate the London Approach as a sensible basis for banks and other interested parties to co-operate, in a constructive way, in deciding the fate of companies facing a cash-flow crisis. In 1990, as the recession developed, we were concerned that some of the conventions for providing support to companies in financial difficulty that had emerged in the early 1980s might have become outmoded or simply forgotten. We therefore instigated a series of discussions with banking groups which showed considerable support for the London Approach. More recently, we have been highlighting some of the areas of contention which have arisen during the past four years, with a view to ensuring the London Approach remains effective and up to date.

As *peacemaker*, we try to help banks resolve differences of view which threaten to undermine an attempted workout. We are willing to be approached by any bank or other interested party which thinks that our involvement will help smooth the path to an eventual agreement on the terms of a workout. Since the start of the recession, we have been actively involved in some 150 workouts, and have been kept informed of many others by the banks concerned. Our aim is to break log-jams and to seek a solution which represents an acceptable compromise for those concerned. In other words, we act as an ‘honest broker’.

I should stress that we have no statutory powers for what we do as an intermediary in the context of workouts. It is not part of our supervisory responsibilities; we rely instead on the authority vested with us by the constituent members of the London banking community, who continue to seek our assistance in resolving difficult issues.

Track record

The London Approach has undoubtedly been useful during the recession of the past four years, although there is inevitably room for further improvement. A large number of

companies owe their continuing existence to the fact that their bankers and, in some cases, bondholders and other creditors followed its precepts in deciding the terms of a collective financial restructuring. It is in everyone's interest that businesses which are basically viable should be kept alive; value is maintained for shareholders as well as other creditors, jobs are preserved and productive capacity is kept in existence.

However, no one claims the London Approach is perfect. Perhaps its greatest strength is its adaptability. It needs to be kept under review to ensure that its effectiveness is not diminished by financial innovations or new market practices. Indeed, we should always be on the look-out for ways in which it can be made more effective. For this reason, I and my colleagues in the Bank of England have pursued—and added to—an 'Agenda for Action', designed to focus attention on resolving tricky issues and learning lessons from experience.

Main issues

We have publicly flagged the following questions and broad areas of concern during the past 18 months:

- (i) How to improve communication between borrowers and lenders in order to ensure problems are addressed at an early stage.
- (ii) Inadequacies of loan documentation and the possibility of introducing majority-voting provisions, instead of unanimity.
- (iii) Concern at the level of advisory fees—and sometimes banking charges—and how to introduce greater accountability for costs.
- (iv) Is trading in impaired debt helpful or disruptive to the process of preserving value?
- (v) Corporate governance and the responsibilities of banks who become shareholders.
- (vi) Increasing the level of trust among parties to a workout.
- (vii) Involving non-bank creditors, eg bondholders or trade creditors, in workout negotiations.
- (viii) Encouraging equity or mezzanine investors.
- (ix) The linkage between statutory insolvency procedures and the London Approach.

Distressed debt

Much of what I have said so far is by way of background. However, I make no apology for that, as I consider it essential to understanding the culture in which debt-trading in the United Kingdom must evolve.

For the past 18 months or so, my colleagues and I at the Bank of England have taken a close interest in the evolution of the secondary market in distressed corporate debt within the United Kingdom. We have sought to respond to the widespread uncertainties and questions posed by the whole range of interested parties.

The Bank of England has three main interests in this market:

- If it can introduce liquidity into banks' loan portfolios, this should increase the potential for sound portfolio management. A parallel can obviously be drawn here with the secondary market in third-world debt. In addition, if the market were sufficiently deep and well informed, it might provide a useful guide to the extent of provisioning which might be appropriate in individual cases.
- Irrespective of the potential attraction of the market, we have an interest in the efficiency and reputation of London as a financial centre. A responsible and professional market could enhance London's standing, but some of the press coverage and concerns expressed to us—particularly by banks already established in London—highlight the damage and uncertainty that can arise from poor communication and questionable practices. A good example of this relates to the way 'inside' information might be gained and used for profit.
- Our third interest is in the impact this market might have on the established culture in the United Kingdom for dealing with companies in financial difficulty. In this respect, the market represents something of a two-edged sword. There are clearly dangers of new players, unfamiliar with the legal and cultural mechanisms which operate in the United Kingdom, disrupting well-intentioned efforts to preserve value in viable businesses. Equally, we have first-hand experience of debt sales providing a solution to fundamental disagreements between established lenders: in the longer term, the market could even introduce a new source of 'mezzanine' or equity finance to replace what are often perceived as excessive amounts of bank lending for individual businesses.

Our approach has been threefold:

- (i) to recognise the potential benefits that a professional market could bring; but
- (ii) to draw attention to the potential disruption to corporate workouts which could arise; and
- (iii) above all, to learn more about the market—and the players within it—and to encourage constructive dialogue between them.

I have always made clear that our interest is *not* as a supervisor or 'regulator' of the market. In exploring how

best to reconcile debt-trading with the London Approach, for example, we have been asking for ideas and reflecting those ideas back to a wider audience in order to judge the reaction.

Some have argued for effectively banning the trading of debt—particularly at sensitive times—while others have responded by arguing the case for total freedom of action. I understand this latter response but, if interpreted literally, it would preclude the London Approach itself. The UK banking community recognises this in adopting the London Approach and has implicitly accepted some diminution in the sovereignty of lenders, in the interest of the collective good of the whole community. This is because they recognise that it is in their wider interest in the long run.

As the debate about the pros and cons of debt-trading has progressed, the volume of trading has continued to grow. One of the consequences of this is that market practices have begun to evolve, and speculation about the unknown has begun to be replaced by hard experience. This experience seems generally to have been reassuring. One of the ideas initially advocated by a significant number of people—and mooted by myself in earlier speeches—was the idea of a closed season on trading to avoid disruption at sensitive times. After a fairly wide discussion among a range of banks, both British and foreign, this has now been firmly rejected. However, it will of course remain open to any group of lenders to agree amongst themselves to restrict their activities, either in their original loan documentation or at the time when a borrower's difficulties become apparent.

A second possibility we have been discussing is whether, instead of a moratorium on trading at particular times, there should be a 'code of conduct' which sets out the behaviour expected of people when entering into deals. What I am about to explain comes close to that, but recognises some real difficulties. For example, how can one ensure a common understanding of the 'code' without writing it down, and how—if you do write it down—do you prevent people from focusing on the letter of the code in a legalistic way, rather than upholding the spirit which lies behind it? Therefore, for the time being, it might be best to set aside the idea of a formal code of conduct.

Recommendations

What I want to outline to you now is how I believe the spirit of London Approach can be (and arguably already is being) extended to encompass secondary trading in distressed debt, in order to increase the liquidity of the market without causing unnecessary disruption.

Debt-trading should be conducted in a positive and constructive spirit; sellers should ensure that potential

buyers are aware of the UK culture for dealing with companies in financial difficulty including, particularly, the London Approach. I have argued in the past that a failure to do this would be tantamount to misleading.

Institutions intending to sell their debt are encouraged to inform their fellow lenders of these plans. This will often occur naturally in the process of gaining a borrower's consent. Either way, I would hope it would assist in the process of managing unavoidable publicity, minimising any unnecessary fragmentation in the number of lenders, and in preserving a positive and constructive understanding between lenders so as to minimise the scope for damage to the underlying businesses.

What I have described is a modest extension of a common-sense approach, which I hope you will all feel able to accept. But it is part of a continuing process, not an end in itself. There are many aspects of the market which could—and I hope will—be considered further in the coming months. A classic example would be the issue of 'inside information'—what can legitimately be used, or not used, to guide trading or investment decisions?

Future role

Finally, I should perhaps explain what I see as the continuing role for the Bank of England in this market. I earlier characterised our role within the London Approach as part missionary and part peacemaker. That metaphor is equally useful in this respect. As *missionary*, we will continue to encourage debate and communication, and to support the evolution of a professional market for trading distressed corporate debt in the United Kingdom. We will welcome continuing contact with each of the players involved, and stand ready to help 'facilitate' this process if and when required.

By seeking to extend the London Approach to encompass debt-trading, we are implicitly extending our role as *peacemaker*. In the same way as we have invited bankers in the past to seek our help as honest broker in reconciling difficulties among lenders, so in future we will be happy to be approached by new investors who believe they have a constructive solution to offer but feel they are not being given a fair audience, or are finding it impossible to get a minority institution to join the party! By the same token, we might take it upon ourselves to contact those new lenders—and offer our help or 'good offices'—if they are cited to us by others as apparently causing difficulty: our motives in these circumstances will, I hope, be judged on their merits at the time. I am sure that, with experience, these new lenders will embrace the London Approach for all the same reasons that the banking community has found convincing in the past.