# Credit Meltdown Notes on 2008 developments Johan Jol Februari 2009

#### Introduction

- Introduction
- Overview of year 2008
- Causes of the financial crisis
- What happens next?
- Documentation issues; a changed landscape
- Proposal on the new Dutch Insolvency Rules

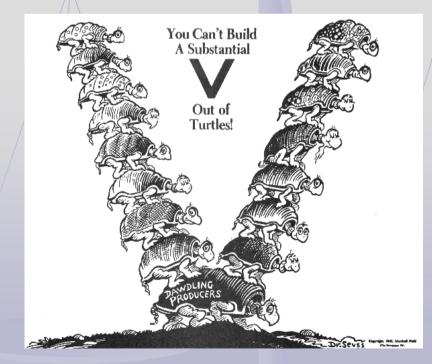
## What happened since February 2008, the Credit Meltdown

Credit Crunch deepened into a Credit

Meltdown



**Bron Getty Images** 



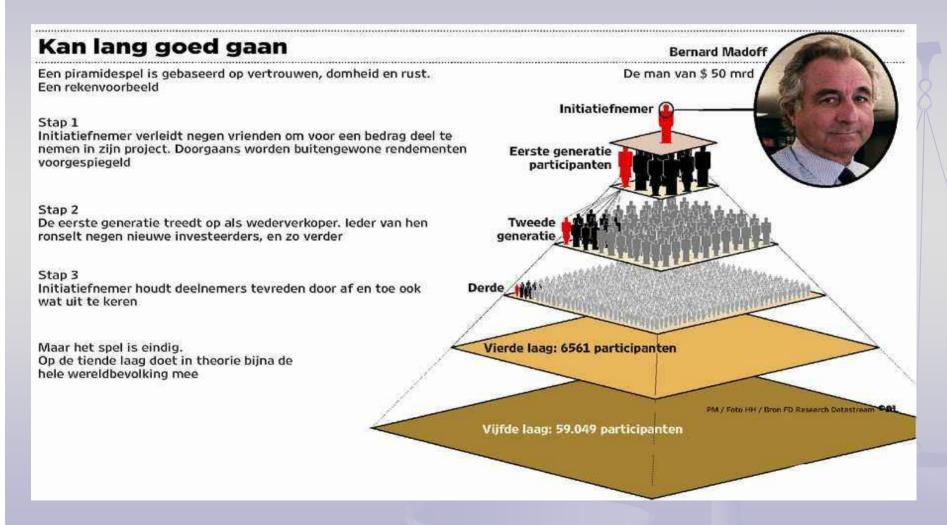
### Timeline I

- February 16: Grameen Bank of Bangladesh of Yunus has made its first micro-finance loans in New York
- May 22: Moodys acknowledges that \$ 4 billion of complex debt products are incorrectly rated AAA
- September 7: Freddie Mae en Fannie Mac nationalised
- September 15: Lehman announces it files for Chapter
   11
- Onder andere ontleend aan: http://www.uiowa.edu/ifdebook/timeline/Credit\_Crisis\_Timeline.pdf,
   Financial Times, Financiële Dagblad en voor wat betreft het NL deel ook: De Kredietcrisis van
   Willem Vermeend (2008)

### Timeline II

- September 16: AIG is saved by US
- September 29: Fortis is (partly) acquired by NL, B, and Lux and Hypo Real Estate is rescued by D
- September 30: Dexia saved B, Fr and L
- October 1: Collapse of Sigma finance, last surviving SIV
- October: NL state makes state aid available in an amount of Eur 20 billion to financials and Eur 200 billion to guarantee loans to financials
- December 12: Madoff Ponzi Sceme detected

#### **Madoff Ponzi Sceme**



Bron FD 16-12-2008

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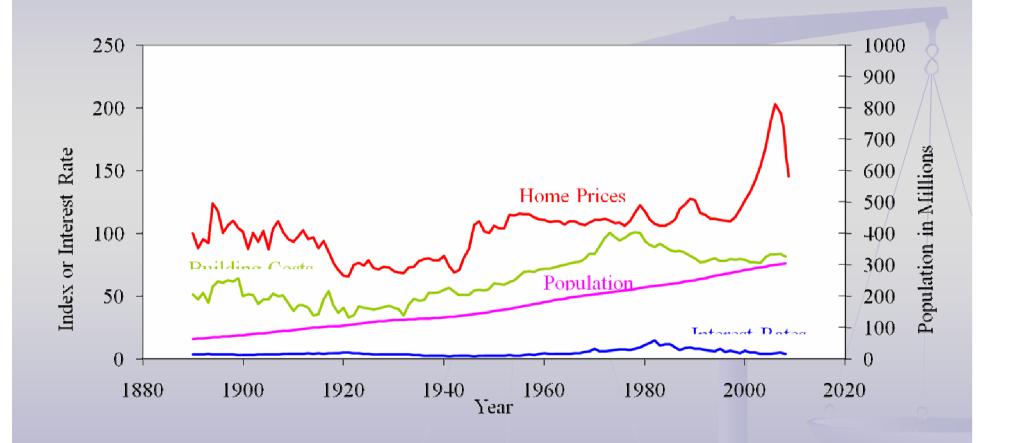
To straighten out the legal hitch

## Causes of the Credit Meltdown

- US Real Estate Asset Bubble, combined and/or enhanced by the irresponsible lending methods
- Incentive structure in financial institutions
- Failure of checks and balances financial institutions
- Structured Finance has become too difficult
- Rating agents
- Lack of adequate financial regulation, shadow banking system
- Synthetic Asset Credit Risk Exposure

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### Real Estate Bubbel US



Bron: Shiller Index

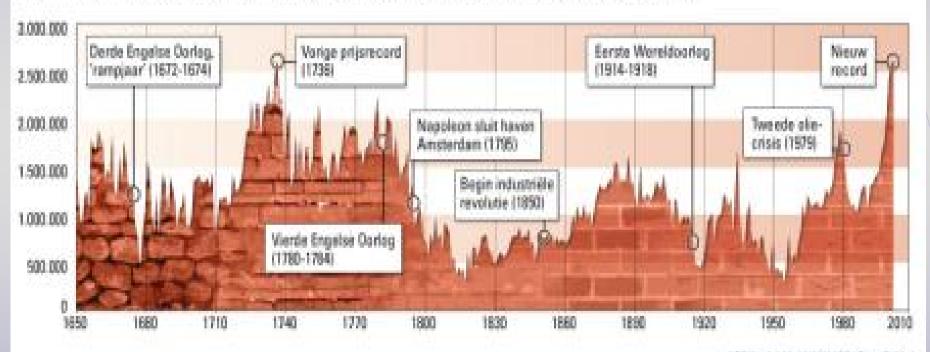
http://www.econ.yale.edu/~shiller/data.htm

To straighten out the legal hitch

#### Real Estate Bubbel NL

#### Hoogste huizenprijzen in bijna drie eeuwen

Prijsentwikkeling waning aan de Herengracht die nu 2,6 miljoen euro kust, teruggerekend tot 1650, gecomgeerd voor inflatie.



NEC Handschlold \$10906 / PB / Branz Ex/Molto:

Bron: NRC 10 november 2007

http://www.nrc.nl/achtergrond/article1853451.ece/Hoogste\_huizenprijzen\_in\_bijna\_300

\_jaar

Zie ook: Eicholtz: http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=598

## Incentive structure in financial institutions

- Short term bonus
- Only upside, no downside
- Motivation is only focused on making profit
- Suggestion: Lower fixed salary and different variable component

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## Failure of checks and balances financial institutions

- Inadequate risk management
  - Operational risk
  - Credit risk
  - Interest risk
  - Market risk
  - Liquidity risk
- Corporate Governance issue:
   Supervisory Board not sufficiently involved
- Not enough "zelfreinigend vermogen"

### Rating agents

- Misunderstood function of a rating, too much reliance on rating
- Conflict of interest: issuing entities pay for rating
- Rating agents make mistakes
- Registration and supervision on rating agents?
- More competition

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## Structured Finance has become too difficult

- Securitization / CDO / CDO Square
- Stable pools / substitution / managed pools

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## Lack of adequate financial regulation

- Micro supervision versus Macro supervision
- The shadow banking system
- Tsunami of dollars
- There is too much leverage going on

### Synthetic Asset Risk

- A synthetic asset is only a virtual asset and not bankruptcy proof (as unsecured benificial ownership of real estate)
- The credit default swap
- Solutions:
  - The collateralised credit default swap
  - The Clearing House solution
  - Ban the CDSW!

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## What happens next, what to do?

- Need of orderly deleveraging
- Credit crisis turns into economic recession
- Redefinition of function of banks?
- New supervision system?
- Redefinition of lending criteria, example of Grameen Bank?

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## Consequences for business to business lending (i)

### Before CreditMeltdown

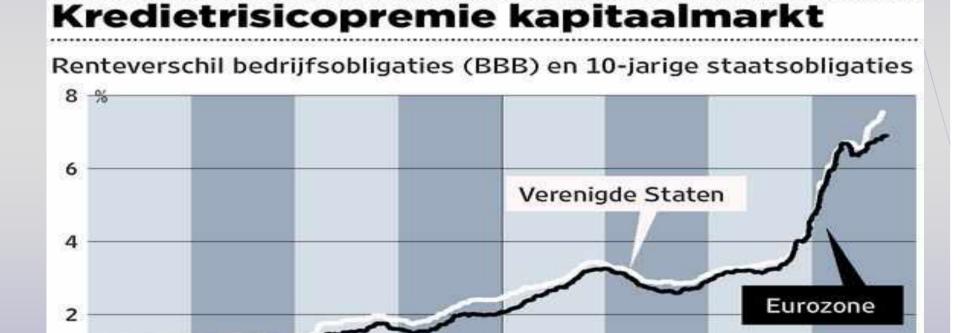
- Easy money period
- Shadow banking system results in extreme leverage, building up the pile of debt,
- a Pyramid sceme in leveraged finance, refinancing a deal with higher debt
- Hugh amount of debt to service

## After CreditMeltdown

- Financing difficult to obtain
- No shadow banking system and banks struggling with their balance sheets
- Businesses still have higher debt to service
- Refinancing possibilities difficult
- Risk perception is changed

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## Consequences for business to business lending (ii)



FR / CPB CAL

2008

2007

0

## Credit Documentation before Credit Meltdown

- Borrower friendly
- B and C only loans structures, highly leveraged, limited security
- Cov-lite/loose loans
- Toggle instruments, equity cure rights
- Fundable term sheets, bridge and interim funding agreements
- Reverse Flex and absence of upward flex
- Mulligan rights, Yank the bank and Snooze and loose provisions

## Credit documentation after the Credit Meltdown

- More lender friendly
- Structural issues, return of the A loan
- Covenants, including full financial covenants
- Flex rights broadened
- Equity cure rights less aggressive
- Focus on restructuring issues: Defaults!





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## DOWNJONES





## Sample issues in Credit Documentation \*

#### Governance Issues

- Amendments and waivers
- Resignation of an agent
- Transfer provisions
- Snooze and lose
- Delay and it's ok
- Yank the bank

#### Other Issues

- Material Adverse Change
- Market disruption

<sup>\*</sup> Text clauses derived from LMA standard

#### **Amendments and waivers**

- Majority Lenders Consent versus
   Supermajority Lenders Consent versus All Lenders Consent
- All Lenders often:
  - Extension of date of payment any amount
  - Reduction of Margin or principal, interest, fee or commission
  - Increase Commitment
  - Change Borrowers / Guarantor
  - Release Security (\*)
  - (\*) advantage of majority lenders consent

### Resignation of an Agent

- Sidestep: Defaulting Lender goes bust
- Facility Agent goes bust
- Security Agent goes bust
- Solution for Security Agent Problem: the bankruptcy remote Security Agent

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### **Transfer provisions**

- What is a transfer
- Restrictions on transfer
- Pros en cons

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#### Snooze and loose

- Failure to response results in loss of voting rights
- Upside and downside

"If any Lender fails to respond to within X Business Days (unless the Borrower and the Agent agree to a longer time period in relation to any request) of that request being made, its Commitment and/or participation shall not be included for the purpose of calculating the Total Commitments or participations under the relevant Facility when ascertaining whether any relevant percentage of Total Commitments and/or participations has been obtained to approve that request."

### Delay it is ok

- Failure to respond results in deemed acceptance
- Upside and downside

"If any Lender fails to respond to a request for a consent, waiver, amendment of or in relation to any of the terms of any Finance Document within X Business Days (unless the Borrower and the Agent agree to a longer time period in relation to any request) of that request being made, it shall be deemed to have granted such consent or waiver or consented to such amendment."

### Yank the Bank

- Forcing out a lender
- But what's is the price

"then the Borrower may, on X Business Days' prior written notice to the Agent and such Lender, replace such Lender by requiring such Lender to (and such Lender shall) transfer pursuant to Clause X (*Transfers by Lenders*) all (and not part only) of its rights and obligations under this Agreement to a Lender or other bank, financial institution, trust, fund or other entity (a "Replacement Lender") selected by the Borrower and which is acceptable to the Agent (acting reasonably), for a purchase price in cash payable at the time of transfer equal to the outstanding principal amount of such Lender's participation in the outstanding Utilisations and all accrued interest, fees and other amounts payable in relation thereto under the Finance Documents."

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### **Material Adverse Change**

- Business MAC versus Market MAC
- Drafting Issues

### **Material Adverse Change**

Typical clause in outline

"Any event or circumstance which [the Majority Lenders [reasonably] believe] has or is reasonably likely to have a Material Adverse Effect is an Event of Default.

- "Material Adverse Effect" means [in the [reasonable] opinion of the Majority Lenders] a material adverse effect on:
- (a) the business, operations, property, condition (financial or other wise) or prospects of the Borrower Group taken as a whole; or
- (b) [the ability of a Borrower to perform [its obligations under the Finance Documents]/ [its payment obligations under the Finance Documents and/or its obligations under Clause X (Financial ratios) of this Agreement]]/[the ability of the Borrower Group (taken as a whole) to perform [their obligations under the Finance Documents]/[their payment obligations under the Finance Documents and/or their obligations under Clause X (Financial ratios) of this Agreement]]; or
- (c) the validity or enforceability of, or the effectiveness or ranking of any Security granted or purporting to be granted pursuant to any of, the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents."

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### **Market disruption**

- When applicable
- What is the result

of FURIBOR.

(b) In this Agreement "Market Disruption Event" means:

deposits in the Relevant Interbank Market would be in excess

(i) at or about noon on the Quotation Day for the relevant Interest Period the Screen Rate is not available and none or only one of the Reference Banks supplies a rate to the Agent to determine EURIBOR for the relevant currency and Interest Period; or (ii) before close of business in [Amsterdam] on the Quotation Day for the relevant Interest Period, the Agent receives notifications [from a Lender/Lenders (whose participations in a Loan exceed X per cent. of that Loan] that the cost to it of obtaining matching

## Proposals on New Dutch Insolvency Rules

- Comments of market participants are out. Currently under review
- Too much to handle currently
- Does not help in restructuring practise but most likely hinders it even more
- Legal Houdini's proposal for the hold out problem

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