

## THE CHANGING FACE OF THE CITY<sup>#</sup>

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Today, I want to focus on what was until recently called a *credit crunch* which has now turned into a *credit crisis* and, in the City, become something of a disaster with jobs and markets disappearing. I am going to look at the origins of the current economic situation and the implications of this for legal work in the City.

If I have time I will also mention some recent research about the differences between men and women when it comes to appetite for risk taking and the implications of this for the banking sector in particular.

### THE ORIGINS OF THE CREDIT CRISIS

All commentators agree that the origins of the current crisis can be firmly laid at the door of the sub-prime mortgage fiasco in the United States. How is it possible that something that sounds so local to a country and a market could possibly have caused what now appears to be a worldwide recession? As this lecture progresses I hope you will see how the financial markets and the legal products that support the creative structures that are used to keep money moving round the globe are so intricately connected that a crisis in one large and important market like the USA can impact on all financial markets.

### SUB-PRIME MORTGAGES

What are sub-prime mortgages? These are mortgages advanced to people who would not have qualified for a traditional mortgage because they either have no credit record or have a poor credit rating due to a history of failing to pay or owe comparatively large sums on unsecured loans or have large credit card debts etc. Prime mortgages are those made to people whose credit rating suggests that they will be a good credit risk because they have relatively little debt and have a solid repayment history.

When banks lend to people with a poor credit risk those borrowers typically pay a much higher interest rate for their loan than borrowers with a

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good credit history so sub-prime borrowers would pay very high interest rates for their loans making their borrowing very costly. Excessively high interest rates can be challenged in the courts in some countries, for example, an HSBC subsidiary<sup>1</sup> recently was forced to settle a class action brought by a number of borrowers for unconscionable lending. So while banks can charge more interest for these types of loan they have to be careful not to overstep the mark into an unfair relationship.<sup>2</sup> Whilst the higher interest rates charged means that the bank is being paid extra for taking the extra risk of default, the impact of these rates on borrowers can be an increase in defaults as it is harder for them to afford the repayments.

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<sup>1</sup> “According to a lawsuit filed in Illinois, HSBC found customers by scanning lists of people who held mortgages and also had high credit card balances with K-Mart, Best Buy, Costco and other retailers affiliated with HSBC that provided the lists. After aggressive mailings and phone calls, HSBC would “trick” the homeowners into providing their Social Security numbers, which allowed HSBC to gain access to their complete credit histories, and use the information to talk people into high-interest consolidation loans, the suit says. The loan amounts were so high - and with interest up to 20 percent - that they often far exceeded the value of the homes, and made it impossible for the family to ever refinance with a competitor, according to the lawsuit. HSBC settled that lawsuit, denying any wrongdoing. It has since been sued by ACORN, the grassroots organisation, and others. HSBC has plenty of company.” Inter Press Service: Homeowner Rip-Offs Spark Scores of Lawsuits: March 12, 2009 By Adrienne Appel.

<sup>2</sup> Consumer Credit Act 2006 inserting new provisions into the Consumer Credit Act 1974 on Unfair relationships between creditors and debtors:  
Section 140A

- (1) The court may make an order under section 140B in connection with a credit agreement if it determines that the relationship between the creditor and the debtor arising out of the agreement (or the agreement taken with any related agreement) is unfair to the debtor because of one or more of the following—
  - (a) any of the terms of the agreement or of any related agreement;
  - (b) the way in which the creditor has exercised or enforced any of his rights under the agreement or any related agreement;
  - (c) any other thing done (or not done) by, or on behalf of, the creditor (either before or after the making of the agreement or any related agreement).
- (2) In deciding whether to make a determination under this section the court shall have regard to all matters it thinks relevant (including matters relating to the creditor and matters relating to the debtor).
- (3) For the purposes of this section the court shall (except to the extent that it is not appropriate to do so) treat anything done (or not done) by, or on behalf of, or in relation to, an associate or a former associate of the creditor as if done (or not done) by, or on behalf of, or in relation to, the creditor.
- (4) A determination may be made under this section in relation to a relationship notwithstanding that the relationship may have ended.
- (5) An order under section 140B shall not be made in connection with a credit agreement which is an exempt agreement by virtue of section 16(6C).

Most sub-prime mortgages were set up with a low cost start (where the borrower initially makes smaller repayment instalments but as time goes by – typically each year for 3 – 5 years – repayment instalments increase in value) but as the loan continues increasingly large sums are required to be paid monthly to repay it. Low cost starts assume that the borrower’s income or available money will increase over time – but if the borrower falls out of work or just cannot afford the higher payments – then the increasing demands can force the borrower to default leading the bank to foreclose on the mortgage in order to recover the loan and outstanding interest.

As the economy in the USA began to falter and interest rates increased and unemployment began to rise increasing numbers of borrowers found themselves unable to afford to pay the increasing costs of their mortgages resulting in a massive increase in the number of mortgage defaults in the sub-prime market.

Even so, had the property market held up and property prices continued to rise the security for the loans would have been of value. However, with the problems in the US economy becoming ever more acute the value of property began to fall steeply. Homes could not be sold. US banks lending to sub-prime borrowers began to find that the security for the mortgage – the borrower’s home - ceased to be of much value as security. The model on which the loans had been made began to fall apart as the banks were finding that they could not recoup their money because homes would not sell and when they did sell would sell for less than the value of the mortgage and more often than not considerably less than the purchaser paid for it. The more foreclosures, the greater the number of properties on the market, and the lower the price those properties could command, the reality of supply and demand curves meant too many homes for sale in a falling market and the banks began to lose money when seeking to enforce their security.

## **WHY WASN'T THE SUB-PRIME MORTGAGE FIASCO CONFINED TO THE USA?**

UK headquartered banks (and not only UK banks) had been watching the sub-prime market with some interest. Banks are always looking to expand into new markets that offer their business profit growth potential. To attract investors and keep institutional investors satisfied all businesses quoted on the Stock Exchange are constantly looking for ways to increase their attractiveness. The models which enabled banks to assess risk and lend to sub-prime borrowers appeared to provide a tried and tested methodology to enable banks to lend to a raft of brand new consumers in the so-called “emerging markets” like China and India. In China and India many of those who had previously made their living in agriculture were beginning to move away from the land and into earning their living from employment in

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manufacturing, often working for western companies outsourcing their production and service requirements to cheaper countries. The banks were keen to tap into these markets and gain new customers who would be becoming consumers requiring credit – particularly since their traditional markets had near enough reached saturation point except for new products.

HSBC provides a good example of this type of business planning. HSBC's strategy for growth was to expand their business in the “emerging markets” of South America, Africa, China and India where they could see vast numbers of new consumers keen to use credit. They bought Household Insurance – a US bank specialising in sub-prime lending – which had developed a complex mathematical model to assess sub-prime risk. They planned to use this model in assessing the risk of taking on new customers in the emerging markets.<sup>3</sup>

### **OFF-BALANCE SHEET**

A balance sheet gives a snapshot of a company's financial situation at a given moment. It shows how effective a company is at trading, and at doing what it has been set up to do. In order for the balance sheet to look sound banks would typically sell off their loans to other entities - “off balance sheet trading” - so that they would not need to hold capital against them, as banks have to do with conventional loans in case they become delinquent and also to replenish their vaults so that they continue to lend to new borrowers and maintain their liquidity. Banks would sell off loans to investors, earning fees in the process. The borrower would continue to make payments but these would be made to the new owners of the loan. Banks used a host of methods to turn loans over quickly, and creating off-balance-sheet entities - “special purpose vehicles” or “special purpose entities” - was one of them. The entities created typically issued commercial debt (sold small parcels of the loan portfolio to investors, often other banks including investment banks called bonds) to fund the purchase. As the credit crisis peaked, however, it became clear to investors and depositors that banks were in fact exposed to losses from loans they had technically sold to off-balance-sheet entities. In many cases, for example, banks agreed to guarantee the performance of the sold loans (credit derivatives), which means they would be forced to repurchase bad loans if too much of the debt they had sold ended up in default. The extent of this off-balance-sheet trading meant that investors found it difficult to assess how much off-balance-sheet risk each large bank was exposed to which is why bank shares have tumbled as investors shy away from buying their shares for fear of how much exposure they have to these

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<sup>3</sup> See Harvard Business School Case Study on the Acquisition of Household Insurance by HSBC 2004.

toxic assets. These concerns about the risk of investing in banks has also affected the extent to which banks are willing to lend to each other as they fear further insolvencies or forced acquisitions by governments.

Northern Rock provides a good example of the impact which banks unwillingness to lend can have on the market. Northern Rock's model for doing business was to borrow money from other banks in order to lend money to people who wanted to buy houses. When funds began to dry up they ceased to be able to borrow money on the market. As a result they ceased to be able to lend money and so if unable to lend were no longer able to make any profit. This caused the first run on a bank in England for many years and led directly to the government having to guarantee all savings held in the bank and eventually having to nationalise them. We saw the same thing happen in the USA with Bear Sterns, an investment bank. Bear Sterns bought bonds relating to sub-prime mortgages and as soon as the sub-prime market began to disintegrate so did their investment in the bonds – leaving them insolvent and ultimately nationalised.

## **LIQUIDITY PROBLEMS**

So as the loans began to fail and the securitisations of those loans began to become worthless and banks were unable to judge which banks were safe to lend money to because so much of the risk was held off balance sheet they stopped lending to each other. Liquidity dried up because instead of lending their spare cash at the end of the working day to other banks they held on to it.

## **SHORT SELLING**

The final piece of the jigsaw which caused the melt down in the global economy was caused by short selling by the hedge funds. How does short selling work? Typically a hedge fund will borrow shares from institutional investors, for example, pension funds, which own large holdings of shares in quality quoted companies. The hedge fund will pay the institutional investor a fee for borrowing their shares and will then sell those shares in such quantities that the value of those shares on the stock market is affected – usually large sales of quoted shares will cause the value to fall and once the value has fallen to a predetermined level the hedge fund will buy back those shares returning them to the institutional investor and pocketing the profit on the sale and purchase back less the fee to the owners. Their profit is the difference between the sale and purchase price. In this way hedge funds are often said to make money out of manipulating the market by trading shares. In recent months there have also been allegations that they manipulate the market with rumour and innuendo. It is alleged that it was due to such rumours that Lehman Brothers, the 200 year old investment bank was brought down. A rumour was

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spread that they were vulnerable because they held huge numbers of “credit derivatives”. A “credit derivative” is similar in form to an insurance contract. Suppose for example, that a bank has made a huge number of student loans and is concerned that there are going to be a significant number of defaults. The bank will find a third party investor who will agree to cover the risk attached to the loan portfolio for a fixed term interest rate, so say the loan portfolio is worth £1,000,000, the bank might agree to pay 5% annually to ‘guarantee’ its student loan portfolio. In effect this is a bet by the third party insurer that the students will not default on repaying their loan and that the third party will not have to pay out to the bank lender. Typically “credit derivatives” are traded as though shares with purchasers taking the risk that the students in our example will pay their student loans back and that therefore they will not have to pay out on any defaults. Many banks, and it was alleged Lehman Brothers in particular, had invested heavily in credit derivatives guaranteeing huge numbers of sub-prime mortgages and given that these loans were now expected to fail were heavily exposed to liabilities on the credit derivatives. Although credit derivatives are traded they are not traded on the open market as such – they are traded over the counter – as it is called and it was therefore impossible to be sure how significant their exposure was, or that of any other bank for that matter.

It is alleged that the hedge funds merely intended to bring the value of Lehman’s shares down – and then by buying them back they would make a financial killing. However, the market took such a fright at Lehman’s possible exposure that their shares went into free fall, and unlike Bear Sterns, the US government did not bail them out. As a result, there was a run on the shares of all investment banks because it was assumed that if Lehman Brothers were exposed so would be Goldman Sachs, J.P. Morgan, etc. So what we saw was a major run on the shares of investment banks, and a suspension of short selling by the American government for ten days to stop the share prices of investment banks from hitting rock bottom and later we saw the American government having to buy into those banks to shore up confidence in their investment systems.

The American government then brought the investment banks in under the regulatory system used for deposit taking banks which have much more stringent regulatory requirements than those which had been applied to investment banks.

## **BONUS CULTURE**

There has been growing distaste at the huge bonuses paid to reward those who, in the hope of making huge returns, take risks that could ultimately bring a bank down. Since the crisis began all governments have been working together to try and replace the bonus culture with schemes that reward

entrepreneurial spirit but not at the potential cost of destroying the very systems that sustain the economy.

## INTEREST RATES

What are the implications for those working in the ‘legal City’? Much of the work we do is lending work – for most City based practices at least two thirds of their work is bank related either acting for the banks in making loans or supporting share offerings or acting for companies that need to borrow or raise funds on the equity markets. In the current market, even where there is money available to lend since the interest rates offered are so high few can afford to borrow the money they need to fund their business. Why is money so tight at the moment? Banks are worried that if they lend they will not get their money back and in order to balance the risk of loss they will only lend at high rates of interest – more than the market can stand.

Until the current crisis, at the end of each banking day, banks would not want any money left ‘in the safe over night’, and so would lend available money overnight at “LIBOR”. LIBOR is the inter-bank lending rate - a point or so above bank rate.<sup>4</sup> The displayed screen rates for LIBOR and EURIBOR should, however, even in current market conditions reflect the panel banks’ average costs of wholesale funds. An individual bank might pay a little more or less.

LIBOR is important for other reasons too, most commercial loan agreements determine the interest rate for loan by reference to LIBOR (or EURIBOR<sup>5</sup>) adding a few ‘basis points’ (0,25%) over LIBOR depending on their assessment of the risk, the market and how much they want the business – however, currently, instead of being a few basis points above LIBOR – huge rates are being quoted and few businesses are willing to borrow at these rates as business models (which work out rates of return and profit from financings) do not work. So very few businesses want to borrow money at the rates that are prevalent in the market, even assuming they can find a bank that wants to lend them money in the first place.

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<sup>4</sup> LIBOR is set on the basis of the average lending rate that the banks have charged during the course of that day up until 11am in that morning and 16 banks put in the interest rate they have been charging depending on the term of the loan, and an average is taken and that is LIBOR. Most commercial borrowers expect to pay LIBOR plus half a basis point. A basis point is 0.25%, so it is a little margin over the LIBOR rate, making it worth their while to lend.

<sup>5</sup> The BBA LIBOR screen rate and the EU Banking Federation EURIBOR screen rate.

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The lack of money available to business is one of the major issues in the current economic crisis, with most governments seeking ways to encourage the banks to start lending again, particularly to small businesses and for mortgages to purchase houses at rates which are commercially sensible.

Since some banks can no longer borrow in the market at LIBOR, they are looking at their existing loan portfolios and seeing rates that were agreed before the crisis at significantly under what it is costing them to borrow from the money market, consequently some of these banks are seeking ways to increase the interest rates paid by their borrowers on loans and using their lawyers to look carefully at the small print of the loan agreements to help them to do this. There are a number of standard provisions found in loan agreements being used for this purpose. I now want to turn to examine a couple of these.

### **“MARKET DISRUPTION CLAUSES (MDR)”<sup>6</sup>**

Market disruption clauses allow the lender to recover from the borrower the actual cost of borrowing where its actual cost exceeds the reference rate that has been chosen (the LIBOR or EURIBOR reference rate). Most loan agreements contain an MDR. It applies (using the Loan Market Association standard as the example) where an interest rate cannot be determined because the normal reference rate chosen by the parties does not work (because no screen rate is available for the relevant currency and interest period, and insufficient members of the agreed reference panel have provided indicative rates to the agent; or even though the interest rate for that period can be determined using the normal reference rate by close of business on the rate fixing day for that period, a lender or lenders holding participations exceeding a specified threshold (which will vary from deal to deal) have notified the agent that the actual cost to them of obtaining matching deposits in the relevant inter-bank market would exceed the normal reference rate. If either of these circumstances applies, the agent or the borrower can trigger a period of negotiation (up to 30 days) to try to agree a substitute rate. Any substitute rate requires the consent of every lender in the syndicate. If no substitute rate can be agreed the borrower must pay each lender the rate that that lender

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<sup>6</sup> A clause in a facility agreement (or certain other debt documentation) which allows the lenders, in certain circumstances, to calculate interest on a different basis to that on which it is normally calculated. Usually, the clause is drafted so that it operates if: the relevant interbank rate (such as LIBOR or EURIBOR) cannot be established (from either the rate published on a computer screen by a price source vendor such as Reuters or the specified reference banks); or a given percentage of lenders can only obtain matching funding in the interbank market at a rate which is higher than the relevant interbank rate. (PLC Glossary).



notifies as being its actual cost of funding its share of the loan from whatever source it might reasonably select.

Some banks may not be invoking these clauses because it suggests to the market that their liquidity is in doubt as they cannot raise money in the markets at LIBOR.

### **“MATERIAL ADVERSE CHANGE CLAUSE (MAC)”**

MAC clauses are typically found in the mandate letter for a syndicated loan and provide the Mandated Lead Arrangers (MLAs) with a means to renegotiate, or step away from, the underwriting or syndication because there are difficulties in syndicating the deal (gaining participation from a number of banks in making the loan).

### **BASEL 2<sup>7</sup> AND BASEL 3**

The Basel 2 Accord aims to harmonise capital adequacy rules for banks internationally. It provides for linkage between the maximum size of a bank's loan portfolio and its regulatory capital. The idea is to ensure fair competition between banks for deposits and security for investors because we can rely on the fact that banks have enough capital in reserve to cover a significant proportion of their loan portfolio should borrowers default—currently a number of building societies (mutuals) have been downgraded from a risk assessment perspective because they are not able to demonstrate that their capital is adequate to cover the possibility that 40% of their loans might default. Some of the banks have very worrying loan to capital ratios, e.g., RBS, HBOS with loan to capital ratios in excess of 100%. The amount of regulatory capital that a bank must set aside will vary depending on the risk weighting ascribed to its various loans and this can change during the currency of the loan, for example, because the credit rating of the debtor changes, or the law affecting the enforceability of the security or other contractual arrangements change. Basel 3 requires the banks to monitor constantly changes to the risk weighting of their loan portfolio including changes in every jurisdiction in which they do business.

In order to ensure that banks comply with the Accords, the UK government has taken shares in a number of banks at risk because they have insufficient capital so as to increase the capital that each has. Interestingly, most loan agreements contain a provision requiring the lending bank to be in compliance with the capital regulatory framework. In most cases borrowers

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<sup>7</sup> The International Convergence of Capital Measurement and Capital Standards, a Revised Framework – Basel Committee on Banking Supervision 2004 – effective January 1 2008 covering much of the developed world.

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are not enquiring as to the compliance for fear that the financial system will go into freefall. It is possible, but highly unlikely, that action could be taken to close down banks that do not have the capital adequacy required.

### **IMPACT OF THE CREDIT CRISIS ON LEGAL WORK IN THE CITY**

When we are in difficult times like this, generally we see an increase in litigation work because every contract gets fought over. Contract law is the most important subject you can study because everything that you do in practice depends upon it.

However, we have also seen a decrease in equity capital market work because in situations like investors are unwilling to take risks on buying more shares in a company, so if a company wants to raise capital (rights issues) by putting more shares onto the market it cannot be sure that anyone will want to buy them. None of the banks want to guarantee (underwrite) these sales so we see a downturn in rights issues, mergers and acquisitions, initial public offerings, etc. What comes in instead is more work on insolvencies and restructurings,

Much of the capital markets work – bonds, derivatives etc., has virtually disappeared as these clever financial instruments have taken much of the blame for the current economic situation.

Property values are down and few clients think that prices have hit rock bottom yet – so property developers are standing back from the market until they believe that property could be on the turn. Equally, investments in new major infrastructure projects are reduced as the cost of borrowing to fund them is just too high.

In a global economy, we have to start looking at markets elsewhere in the world in the hope that some will not be affected by a downturn: initially at least most believed that the Middle East would continue to bubble, but this time, because the crisis is global even the Middle East is suffering..

Quieter times doing deals for clients often provides time for reflection and creative thinking about new legal products – so we can expect a number of new legal products to be developed particularly around Islamic financing, carbon capture, carbon trading, carbon storage.

### **A FINAL WORD ON RISK**

At the start of this lecture I mentioned some research on women and appetite for risk. Many commentators on the current crisis have said that it is the excessive risk taking in the City (and markets across the world) that has

caused the current turmoil. Some interesting research by Tilburg University in the Netherlands in 2008<sup>8</sup> shows some interesting results.

They took 96 matched pairs of men and woman executives, doing similar jobs in UK listed companies between 1998 and 2004. They found when they compared their pay packages a 19% gap in initial pay, and vast disparities in bonus payments. They then focused on identifying the reasons behind these results. They found a number of stereo-typical assumptions in play whereby top male executives were seen as dynamic risk takers whose actions have a decisive effect on company performance whilst women were seen as being relatively passive and having a low impact on the performance of the company and a weak appetite for risk. In the result – women’s pay was little affected by how well or badly the organisation was doing – whilst men’s pay was heavily impacted; if the company did badly men would be punished for that poor performance and receive no pay increase and no bonus, if the company performed well, they would be hugely rewarded in the pay package they would receive. They gave the example of women getting bonuses of £12,000 a year during their whole term of employment, whilst male bonuses varied between nothing and £100,000.

Finally, looking back to the causes of the credit crisis does this research provide a moral for the future? Do we need more women in key roles in the financial institutions to ensure a safer approach in the financial markets of the future?

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<sup>8</sup> See <http://www.guardian.co.uk/business/2008/sep/14/executivesalaries.women>