Feeling the squeeze, Part 2: How care sector borrowers can be rescued from a breach of banking arrangements caused by poor property value

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Abstract
This paper builds on the author's previous paper, 'Feeling the squeeze: how borrowers in the care sector will be affected by the climate in the lending market and what can be done about this?' (*Journal of Care Services Management*, Vol. 2. No. 2). It considers the impact of a fall in market values for borrowers in the care sector and, in particular, the effect on the loan to value (LTV) ratios used by lenders. It goes on to examine the solution to falls in LTV ratios offered by a number of financing techniques available to borrowers in the sector, namely the use of other assets, hanging debentures, the 'pool' approach and asset swaps. It concludes that these techniques can not only offer a lifeline in difficult market conditions, but also put the borrower in a strong position to take advantage when more favourable trading conditions occur.

Keywords:
care sector, property value, property finance, hanging debenture, close care unit (CCU), asset swap

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CURRENT OUTLOOK

The lending climate has not improved since January 2008. The forecast for the return of the summer's blue skies is a matter of opinion, although all seem to share the view that the metaphorical

sun will not be shining much this year (if at all). Looking forward then, what are the ongoing vulnerabilities for care sector borrowers?

MARKET WEAKNESSES — FALLING PROPERTY VALUE

Potential negative impact of property value

The value of property and revenue are fundamental features of most care sector funding arrangements. Part of this year's grey seems to be the gloomy view of the value of property. This paper looks at the potential negative impact of the value of property on the care sector borrower and how certain innovative financing techniques can 'rescue' the borrower from adverse consequences of this impact.

WHY DOES THE VALUE OF PROPERTY MATTER?

Property as security using 'loan-to-value' (LTV) ratio

Why does the value of property hold such significance for many borrowers, including those in the care sector? The answer is because of the way in which lenders structure their lending arrangements. Lenders depend upon the value of property to cover the lender's money. In short, a lender requires its money to be sheltered by security given by the borrower to the lender — a lender's umbrella. The amount of security required by a lender to cover any one lend is often determined by a 'loan to value' (LTV) ratio. The LTV ratio is agreed between the lender and the borrower. This is explained below in the section on borrowing basics.

When 'cover' is insufficient because property value has fallen, a default might be called. If the lender does not have sufficient cover, for example, in line with the agreed LTV ratio, more often than not it is entitled to call a default and demand repayment in full. The hapless borrower thus falls foul of its funding arrangements because of external market forces.

Innovative financing techniques can prevent the LTV ratio breach

All is not lost, however, and there are a number of innovative financing techniques that a borrower can deploy to help it weather the storm and 'cure' the LTV ratio breach. Some of these techniques can offer the borrower significant advantages when fair weather returns. These innovative financing techniques include the following and need to be looked at with an understanding of 'borrowing basics' (please see below):

Examples of these techniques

- other assets brought in to support the LTV ratio;
- the hanging debenture;
- the pool approach;
- asset swaps.

How these and other innovative techniques can apply to the commercial advantage of the borrower, in particular an acquisitive borrower, is also explained under 'Commercial advantages of these innovations', below. Although not yet commonplace, all four of the above techniques have been used in lending arrangements within the care sector.

BACKGROUND: BORROWING BASICS

Giving the LTV ratio its context

To explain the business of borrowing, this paper looks at the following borrowing basics:

- the basic structure of lending arrangements;
- how the LTV ratio fits in to this structure;
- how does a breach of an LTV ratio occur?

The basic structure of lending arrangements

Homes are used as security for the lender

Lendings are secured so that if the borrower does not repay its loan, the lender has 'security' that it may use (ie sell) to convert into money to repay the loan (plus interest, costs and expenses that the lender is owed) and the lender 'comes out clean'[1] and dry from beneath its umbrella. This security is property that is charged to the lender as security for the relevant lend. Invariably, in the case of a care sector borrower, the property that is so charged is a home and/or other 'real estate' such as close care units (CCUs).

The 'charging process' ensures that the lender has the right to sell the property, even though the property does not belong to the lender but belongs to the borrower or another legal entity (including, perhaps, individuals[2]). The proceeds of that sale can then be applied to repaying the borrower amounts owed to it by the lender. (The surplus left over after any such sale is returned to the original owner of the property, subject to any other claims on these funds.)

The rights to sell are written in the bank's lending documents

How does the charging process give the lender these rights? The charging process involves the borrower granting a 'legal charge' in favour of the lender over the relevant property. The legal charge is a document. It contains many rights in favour of the lender (as well as restrictions on the borrower)[3] allowing it to sell the property in certain circumstances, such as pre-agreed defaults, and then apply the proceeds of the sale as noted above.[4] The legal charge (as well as other banking documents) prohibits the owner of the property from selling that property and, in most cases, prohibits the use of that property as security for any other funds until the lender has been repaid in full (a debenture would be expected to contain similar restrictions).

How the LTV ratio fits in to this structure

Lenders rely on the LTV ratio to determine how much to lend

Lenders need to measure the security cover — the size of umbrella — needed for a lend. Many lenders use the LTV ratio as a defining reference point to determine the maximum amount that they are prepared to lend any entity, proportionate to the amount of security they are getting. The lender will assess the value of the asset being offered as security and then lend the borrower money proportionate to the value of that asset, calculated by reference to the LTV ratio.[5] For example, if the LTV ratio is 70 per cent, the total of the amount lent must not exceed 70 per cent of the value of the asset(s) of the borrower being used to secure that loan.

Therefore, a borrower with a £10m property available as security for the lender may well be allowed to borrow £7m against that property.

The value of the assets is assessed by a professional valuation carried out for the lender to rely on. The LTV ratio is fed through into the lender's documents as a covenant of the borrower. The covenant is a promise by the borrower that it will ensure that it keeps its borrowings within the required LTV ratio.

How does a breach of an LTV ratio occur?

A breach of an LTV ratio can be caused by the property value going down

If the value of the borrower's property securing the lend falls, the lender's required LTV ratio is breached. For example, say that the above £10m property falls in value to £9m. What then? In this situation, a lender may wish to lend only 70 per cent of £9m, ie £6.3m (for the present purposes interest costs and expenses will be disregarded, which a lender may wish to see also within the LTV ratio). This could mean that the borrower needs either to decrease its borrowings or increase the security given to the lender, so that the LTV ratio is corrected, to be within the agreed proportions.

A breach of an LTV ratio makes a lender nervous. This is because a lender likes to have sufficient 'headroom' in its lending arrangements to be comfortable that if the worst came to the worst and it had to sell the security, it would still be kept dry and 'come out clean', ie all its debt, interest, costs and expenses would be repaid. Then what happens? Such a breach will frequently allow the lender to call a default with the consequences referenced above, ie demand full repayment of sums lent and exercise rights to sell the 'security' if amounts owed are not repaid. It may also trigger other defaults in the financing documents and could even trigger a cross-default into separate financing arrangements the borrower has entered into.[6]

Such a breach may lead to defaults

Innovation can protect the borrower from default

Returning, then, to how innovation can help the borrower faced with a breach of its agreed LTV ratio, this paper will now look at other assets that can be brought in.

OTHER ASSETS BROUGHT IN TO SUPPORT THE LTV RATIO

Background

The easiest cure of an LTV ratio breach is for the borrower to offer additional security to the lender to comply with the ratio. This offering will need to be assets that are not being used as security already. For a lender, any such additional security would ideally be property; however, it may be conceivable for other non-property assets to be brought in to support the LTV ratio breach. If additional property cannot be made available for supporting the lend, the more innovative approach may be taken of looking at other assets to support the lend, perhaps cash in (or moving through) an account that may be charged, or the benefit of receipts due under valuable contracts.

Borrowers may use additional security to support the lend

It is best that these options are negotiated and documented when arrangements are entered into and when the borrower's position is strong.[7] Even if these do not form part of existing arrangements between a borrower and a lender, most lenders are not so churlish as to refuse to consider changes to documents that build in flexibility without harming their position. The extent to which the lender will or must consider these options at the relevant time will depend on the small print in the documents[8] as well as the borrower's relationship with the lender.

Additional security needs to be documented

If the lender agrees to the innovative concept of additional security over non-property assets being accepted to support the lend and 'cure' an LTV ratio breach, this needs to be documented. The documents need to reflect the fact that the LTV ratio may include the value of the additional assets as well as the original property in its calculation.

Release of additional security must also be agreed

Moving this innovation forwards, once lending arrangements can continue to perform within the originally envisaged LTV ratio without the additional security, it is important that the additional security — deemed 'free equity' (being security that is over and above that needed by the lender) — will be released by the lender. Basically, an 'equity release mechanism' needs to be included in the documents.

Equity release mechanism

The advantage of including an equity release mechanism is that, if this is done with reference to the LTV ratio, then in the future, the borrower can obtain release of the surplus assets, which is very much to its advantage as explained below under 'Advantages of the equity release mechanism and asset swap'. Without an equity release mechanism, the borrower can feel restricted and find itself prevented from taking its business forward because a disproportionately large percentage of its assets will be tied up under one particular funding umbrella.

THE HANGING DEBENTURE

Another innovation to consider for the 'squeezed' lender is a concept here called a 'hanging debenture'.

Background

A debenture defined

A debenture is security that tends to encapsulate all the assets of the borrower however big or small and including, for example, property, cash on deposit, the right to receive income under a contract, a right of action which carries an expectation to receive money and the right to receive insurance proceeds etc.

In the most basic of terms, the lender has the right to look to those assets to repay the debt owed to it in a default scenario. Because a debenture gives the lender wide rights over all the assets of the borrower, it tends to be attractive to lenders and for the same reason unattractive to the borrower. Despite this, the debenture is widely accepted as a necessity for many lending arrangements, in particular where there is not enough security over property for the lender to feel comfortable.

How a 'hanging debenture' works

If a borrower has a lend supported by a charge over property, the value of which might be changing, thus moving the borrower towards an LTV ratio breach, it may ask the lender to agree to a hanging debenture instead of a debenture that is 'in place' and registered at Companies House. It is agreed that the debenture hangs and only drops into place if the LTV ratio is actually breached, or breached beyond an agreed margin.

Clarity is needed in documenting this and this innovation can be further improved by building in a 'remedy period' whereby the borrower has the option to cure the LTV ratio breach before the hanging debenture drops, by bringing in other assets as noted above. This means that the debenture continues to hang without settling on the borrower's assets: a two-fold innovation.

The pool approach is very good for a borrower with CCUs

THE POOL APPROACH

This is especially useful where a borrower has units such as CCUs.

Background

Particular to the care sector is the creation of CCUs. Each CCU is valuable and, taken together (depending on the borrower's business), the value of a borrower's CCUs can be substantial and run into millions. A CCU often has the advantage of being a 'stand-alone' property. Each unit will have a value that can be independently assessed.

Dealing with CCUs on a 'pool' basis is another recent example of an innovative financing technique. In summary, the CCUs are taken together and considered as one pool. Thus, the borrower is allowed to continue to deal with the CCUs, for example, to sell or lease them as it wishes, provided that, at any one time, the value of the pool of CCUs does not fall below a minimum specified amount.

The CCU pool value can be allowed in the computations of the LTV ratio calculation. This gives the borrower the flexibility of ensuring that it retains a high pool value of CCUs (for example, by not selling or leasing any for a period). That pool value is added to the value of another asset(s) in the LTV ratio calculation and thus used to prevent a breach of the LTV ratio. This is another two-fold innovation.

Additionally, the CCU pool itself can benefit from an increase in property values which gives the borrower greater freedom to deal with an increasing number of CCUs as it wishes, without an adverse pool value having knock-on effects, for example, on LTV calculations.

ASSET SWAPS

Build the concept of an assset swap into the lending documents

If a borrower has other assets that would meet the LTV ratio requirement, it can request that an asset 'swap' be agreed, rather than simply adding this asset to the lender's security.

This would be a useful approach where the assets to be swapped would, when taken with the existing security, give the lender

superfluous security and, again, this needs to be negotiated and documented.

Future positive consequences of an asset swap are that, when matters improve, the efficiency of security gives the borrower the greatest possible 'free assets' for use as security in other arrangements. This in turn gives the borrower the greatest possible flexibility for fulfilling its future business plans, which is particularly relevant for the acquisitive borrower as is seen below.

How can these innovative techniques, implemented to help during the credit squeeze, be to the advantage of the borrower, in particular an acquisitive borrower?

THE ADVANTAGES OF INNOVATIVE FINANCING TECHNIQUES

How innovative techniques can help in the future

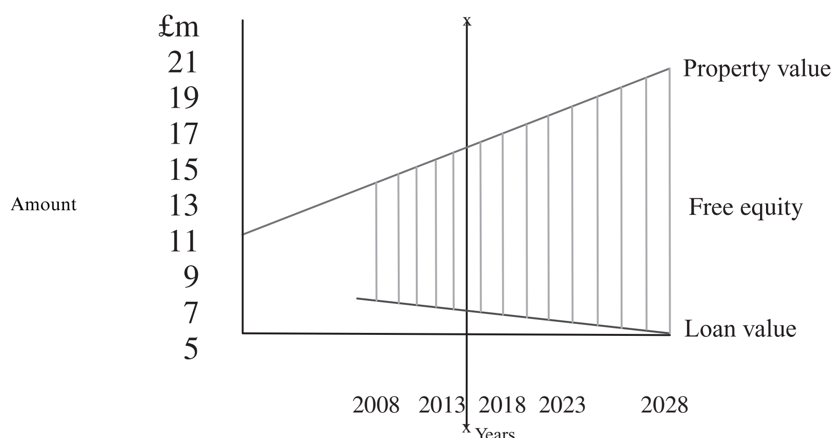
The outlook will not remain relentlessly overcast, and umbrellas will be folded away for a time. The money markets and banking are cyclical. Where loans are made over a long period, as is often the case in the care sector, it is expected that a down cycle will be survived by the life of the loan. The lend survives the downturn and moves with the economy into a more stable and positive lending environment. With this cyclical change comes the borrowers' silver lining, improving free equity. By the time markets recover, part of the loan may well have been repaid and the value of the property securing the lend can be expected to have improved (inflationary features are also a consideration).

The lending markets, like climates, are cyclical — it will get warmer

Following the above LTV ratio example, the loan may well be £5.5m, secured against a property worth say £11m. This gives an LTV of 50 per cent — a significant excess of security for the lender at that time and shown at point 'x' on Figure 1. The widening gap between the lines in Figure 1 is the amount of free equity that the lender has secured but does not need, for example, for ongoing LTV compliance.

The lender can be 'over secured'

What does this all mean for the borrower? It means that it may well then be using an £11m asset to secure a loan of only £5.5m.



Key: Bottom line represents value of loan (a £7m, 20-year loan, repaid in 2028)
Top line represents value of property
Shaded area represents free equity

Figure 1: Fictional LTV ratio example showing increase in free equity over time

The borrower needs the extra security to support other business plans

No matter, one might say. Indeed, no matter if the borrower has no particular plans. But, what about an acquisitive borrower wishing to expand its business perhaps through a new acquisition of another home or complementary business or development? Not many such borrowers can afford to sit on over £5.5m of unused security when looking to raise finance to implement their business plans.

ADVANTAGES OF THE EQUITY RELEASE MECHANISM AND ASSET SWAP

The borrower who has taken advantage of the above innovations, and included the suggested equity release mechanism (so that free equity will be released), and/or made provisions such that the lender will accept a security 'swap', will be able to require the release of free equity (in accordance with agreed terms).

COMMERCIAL ADVANTAGES OF THESE INNOVATIONS

Released assets can be put to good use

There are a number of meaningful commercial advantages for the borrower that includes these innovations in lending documentation, for example, assets 'released' can be used to secure other borrowings. This can be of huge commercial importance to borrowers because the released assets can be offered as security to the same or another lender in order to raise funds for planned acquisitions/development etc.

Competition is a commercial reality

The borrower may wish to stay with its existing lender or enter into arrangements with another lender (thus avoiding having all its eggs in one basket). Either way, provided that the borrower has the flexibility in terms of assets free to be offered as security, the borrower is likely to secure a better deal. It may wish to open up dialogue with alternative lenders to service its debt needs. This may sound harsh from the lenders' point of view, but many lenders recognise and accept that a competitive dialogue is a commercial reality. Some lenders welcome such an approach as an opportunity to 'show their worth', perhaps more so now in a squeezed market.

Ring-fencing gives borrowers necessary commercial freedom

To encourage a 'ring-fenced' approach by lenders — ring-fencing is the limiting of a lender's security to certain 'fenced in' assets — the lender then only has recourse to the ring-fenced assets as security for that particular lend. This can be profoundly important for a borrower that has a number of business interests, which it wishes to keep separate, perhaps because the borrower is part of a group or has a number of businesses operating independently from each other. Each borrowing entity is responsible for its own debts alone and is ring-fenced so that it cannot threaten or be threatened by the effect of another entity defaulting. Furthermore, it may not be commercially appropriate for one business to run the risk of being undermined in any way in the future by having to support another business interest's financing arrangements. Another advantage of ring-fencing is that the borrower can ensure different borrowing entities can do business on their own terms.

CONCLUSION

Innovation paves the borrower's way forward

The squeeze continues and impacts the care sector borrower in particular ways, in part because of a dependency on the value of property underpinning financing arrangements. These economic squeezes, although challenging, offer borrowers the opportunity to look at innovations to rescue them from a breach of their financing arrangements. While breach of the LTV ratio is generally a default under the lending arrangements, the prospect of such is a useful starting point for negotiations that can place the borrower in a commercially strong position in a fairer climate. These innovations not only offer a lifeline in high seas but also put the borrower in a strong position to take advantage of more favourable trading conditions and calmer water.

Acknowledgments

The writer recognises the flexibility and commercial acumen of lenders in their arrangements with care sector borrowers, in particular, Barclays Bank PLC and the Bank of Ireland for embracing the techniques referenced in this paper.

References

1. As noted in Clarke, E. (2008) 'Feeling the squeeze: How borrowers in the care sector will be affected by the climate in the lending market and what can be done about this', *Journal of Care Services Management*, Vol. 2, No. 2, pp. 134–142, it is the lender's money and it is not unreasonable for the lender to adopt the principle of requiring to 'come out clean'. What borrowers are well advised to check is that the lender does not overstep the mark in terms of 'cleanliness' and end up in some way profiting from arrangements ending, for example, by having the benefit of an unduly harsh default interest rate (or even compounded interest). Experience demonstrates that most lenders will accept reasonable curtailment of such terms when asked to.
2. As is sometimes the case in the care sector because, for example, the business might be owned by a trading company while the property is privately owned. Please refer to Clarke, ref. 1 above.
3. Clarke, ref. 1 above.
4. A lender may also have the benefit of a debenture (please see under section entitled 'The hanging debenture') issued by the company in favour of the lender. The company issues the debenture over its assets, which may not include the home if owned by a different legal entity.
5. There are many advantages for lenders using an LTV covenant as a reference point in lending arrangements. These include the fact that (i) the value of the real estate can be easily assessed by a professional valuation. The lender can therefore be confident that, if worst came to worst, it could sell that real estate for the value in the professional valuation — for example, £10m. Therefore, if the lender takes a 'safe' view that it will lend to the borrower provided that its total exposure at any given time does not go beyond, say, 70 per cent of the professional valuation (ie £7m), it will feel that the lending is fine because there is £3m of 'headroom', ie surplus 'equity' leftover in the property so that even in a worst-case scenario for the lender where the property had to be sold quickly for, say, £8m, it would still come out 'clean'; and (ii) only one asset sale is required to be dealt with from an administrative point of view in order for the lender to secure all the proceeds that are required in order for all the indebtedness of the borrower to the lender to be paid off in one fell swoop. All in all a pretty comfortable place for the lender to be in.
6. Clarke, ref. 1 above, under 'Cross-default'.
7. *Ibid.*, under 'Negotiation'.
8. *Ibid.*