

NEW DEVELOPMENTS IN THE SYNDICATED DEBT MARKET¹

Given the difficult domestic and external environment, the syndicated loan market shrank dramatically in both Asia and Hong Kong last year. In 1999, the supply situation is generally expected to remain tight, but top-rated Hong Kong borrowers who are prepared to pay the going market rate should be able to obtain funds without too much difficulty. The biggest question in the syndicated loan market in the coming year is the availability of funds for Mainland borrowers. Since companies cannot deleverage overnight, at least some debt will need to be rescheduled or refinanced. In order to maintain the stability of the system as a whole, banks will have to remain supportive of Mainland borrowers, particularly those with a clear economic rationale for their activities.

It is an honour for me to have the opportunity to address the inaugural luncheon of the Asia Pacific Loan Market Association. As a regulator, I welcome the formation of the Association for a number of reasons. First, it provides a focal point for communication between the HKMA and the syndication market. While it is always welcome to receive the views of individual institutions, as I have done in preparing for this speech, it is also important to have bodies such as the Association which can present the perspective of the industry as a whole. I hope that this luncheon will be the start of a long and fruitful relationship between the Association and the HKMA. Second, the Association can play an important role in fostering the development of both the primary and the secondary markets in Hong Kong, which is by far the leading syndication centre in Asia. It can do so by helping to establish common standards and documentation for the syndication process and for secondary market trading. This is vital if an active and liquid secondary market is to develop. Good documentation helps to protect banks against legal risk that contracts will not be enforceable and thus gives them the confidence to do business. Finally, I understand that it is also the intention of the Association to develop and maintain a central database of information on pricing trends and transactions in both the primary and the secondary market. This internet-based system would not simply be a repository of historic information, but could also be used to facilitate the syndication process and trading in the secondary market. The

benefits of such a system in terms of greater transparency and efficiency are clear.

I am also glad to be informed by your Chairman that one of his plans for the Association is that it should work with the main data providers to establish a consistent methodology for reporting data on the loan market. This would certainly be helpful to observers such as myself who try to make sense of the bewildering array of figures on the volume and value of syndicated loans.

In summary, the Association can become a vital part of the market infrastructure in Hong Kong. It is a sign of the market coming of age in Asia, and I hope that banks in Hong Kong and elsewhere in the region will give the Association its full support. As the Chairman stated in the Association's first Newsletter, you will get out of the Association whatever you put in.

The Association has come into being at a time when the financial markets in Asia are under exceptional strain. If we simply look at the situation in Hong Kong, banks have had to cope with the worst year for the domestic economy since records first began. At the same time, the uncertainties in the external environment and the various speculative attacks on the currency produced extreme volatility in interest rates during 1998. Given the general market environment, it is not surprising that 1998 was not a very good year for syndicated loans. Leaving aside the confusion over the precise numbers, it is clear that loan

¹ This is the text of a speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asia Pacific Loan Market Association Inaugural Luncheon on 27 January 1999.

volume shrank dramatically in both Asia and in Hong Kong. Using figures provided by your Chairman, the volume of loans arranged for Hong Kong borrowers shrank from the 1997 peak of US\$42 billion to only about US\$7 billion in 1998 — a fall of 82%. It must be said that this was a global phenomenon, reflecting a worldwide tendency to deleverage following the over-exuberance of 1997. There is nothing new about this in banking. During the optimistic phase of the credit cycle, competitive pressures cause a rapid expansion of lending during which spreads are rapidly bid down. This is inevitably followed by a cutting back of lending activity and a dramatic widening of spreads as cold reality sets in and the banks become cautious about credit risk. As I say, this has been part of a global trend in 1998, but it has been particularly marked in Asia and in Hong Kong where the initial euphoria in the upswing of the credit cycle made the subsequent crash all the more extreme.

The reduction in loan volume in Hong Kong was partly due to a lack of demand from borrowers as the economy slowed. In addition, a number of companies had already met their borrowing needs in 1997, and aggressive property sales by the developers and the suspension of land sales reduced their need for finance. Having said this, however, the availability of credit shrank dramatically as banks became more reluctant to lend. This is clearly demonstrated by the reduced number of participants in loans to even top quality names such as the MTRC. In this context, I cannot avoid mentioning the impact of the withdrawal of the Japanese banks, simply because of the previous major contribution that they have made in providing liquidity. Again the figures vary, but it has been suggested that they have in the past accounted for as much as 40-60% of the liquidity in any given transaction. Your own Newsletter has provided an analysis which shows that Japanese bank involvement in the four most recent major loans for the MTRC has fallen from 53% in 1994, 40% in 1995 and 43% in 1997 to zero in 1998. This trend can only be partly compensated by increased participation by other country groupings such as the European banks. But even they are displaying greater caution as their head offices have become more nervous about Asian risk in general.

It is not surprising therefore that the market in 1998 was closed for all but the best names and even they had to pay much higher spreads and concede shorter maturities. Changing market circumstances have shifted the balance of power to lenders and have resulted in changes in pricing and syndication methods. Club deals and top-heavy syndications with limited retail participation have become the norm; pricing on new loans is “marked to market”; and there is flexibility for the pricing and the other terms to be adjusted during the syndication process to meet investor demand. As the more marginal lenders drop out of the market, corporate treasurers now have to place more value on long-term relationships with their core banks rather than simply trying to squeeze the last drop out of spreads on each individual transaction. This is a healthy development, but unfortunately not one that will necessarily survive the next upturn in the market.

The conditions in 1998 have also given a boost to the secondary loan market as banks come under more pressure to adjust their balance sheets. Again, the Japanese banks have been the most obvious sellers of loans, but this is something of a special case that is not representative of the development of a genuine two-way secondary market. What might be called the real or underlying secondary market has grown considerably, but remains in its infancy with one or two trades per week. As already mentioned, one of the tasks of the Association will be to help to develop this market. This is certainly something that the HKMA would welcome. An active secondary market can enable more accurate pricing of loans in the primary market. This has already been seen to some extent in 1998, but it is not yet a perfect process since secondary market prices are probably not yet fully representative. The secondary market also adds liquidity to loan portfolios and frees up capacity for new lending. This is a good thing but banks will need to be careful that this does not give rise to the “liquidity illusion” that was demonstrated for example in the case of Long-Term Capital Management. While the banks’ exposure to LTCM was generally collateralized, inadequate thought had been given to what would happen if that collateral actually had to be realized. Similarly, lending banks should not assume that they can trade their way out of a

problem if a loan looks as if it might start to go bad. The existence of a secondary market is not therefore a substitute for proper credit analysis from the outset. Of course, it may always be possible to sell distressed debt if you are prepared to take a big enough hit. But this brings in a further problem that the buyers of such debt may have less of a vested interest to cooperate in workout situations. If they have bought the debt cheaply enough, they may benefit even if the borrower goes into liquidation. This is why HKAB's guidelines on corporate difficulties advise that sellers of debt should ensure that buyers are aware of the guidelines and would be expected to adhere to them.

As regards the outlook for the market in 1999, the supply situation is generally expected to remain tight but top-rated Hong Kong borrowers who are prepared to pay the going market rate should be able to obtain funds without too much difficulty. There are hopes that a revival in the bond market, which we have witnessed to some extent over the two weeks may take some of the pressure off the loan market. As you know, it is very much the HKMA's policy to try to promote the growth of the bond market in Hong Kong. Our latest initiative taken in conjunction with the Stock Exchange is to try to develop a retail market for Exchange Fund Notes through listing and trading them on the Stock Exchange. It is hoped that this would pave the way for similar listings by other public and corporate issuers. We recognize however that this will take time, and in the meantime borrowers will need to continue to rely heavily on the syndicated loan market. Middle market borrowers may however find it difficult to access the market this year. New sources of funds outside Hong Kong may therefore be required — such as the largely untapped US investor market. Access to the latter will however depend on whether borrowers are prepared to pay the necessary price and to provide the transparency that US investors demand.

The big question in the syndicated market in 1999 is however the availability of funds for Chinese borrowers. In the wake of Gitic, it seems that it will be difficult for all but a few select names to obtain new funds or indeed to refinance the sizeable maturities of about US\$4 billion due

this year from the syndicated loan market alone. The liquidation of Gitic and the lack of any special treatment for SAFE registered debt have overturned the assumptions on which banks based their lending decisions to Chinese borrowers. Banks are now supposed to base these decisions on the intrinsic financial strength of the borrowers. It is generally agreed that this is a healthy development in the longer-term. It does appear that the existence of implicit parental guarantees has encouraged over-borrowing and the funds have not always been sensibly used. It is right therefore that lenders should get back to fundamentals and apply conventional credit standards.

The problem is however that this process cannot happen overnight. The transparency is simply not there in many Chinese companies to assess their financial strength, and even if that strength could be assessed it would be unlikely to support the current level of borrowing on a stand-alone basis. But these companies cannot deleverage overnight. It will take time to work down existing debt. This implies that some at least of that debt will need to be rescheduled or refinanced. The alternative is an escalating series of defaults and liquidations that will further damage confidence and increase the bad debt provisions of the banks concerned.

It seems inescapable therefore that banks will have to remain supportive of Chinese borrowers, particularly those where there is a clear economic rationale for their activities. They should also avoid precipitate recovery actions which would result in wholesale liquidations. It may seem strange for a banking supervisor to be saying this, but it is consistent with our concern to maintain the stability of the system as a whole. It is also the reality of the situation. In return for this forbearance by the banks, there needs to be cooperation from the other side. Banks will obviously be looking closely at how the Gitic liquidation is handled. They will also expect to see as soon as possible a clear strategy from the Mainland authorities for dealing with the debts of the other Itics and other Chinese entities. Within the context of this strategy, the banks need to know which companies are going to be supported for restructuring purposes, for example by the injection of fresh capital or good quality assets.

The banks could then formally enter into standstill arrangements with such companies and perhaps even provide them with new money for necessary purposes. The proposed arrangements for Guangdong Enterprises provide a model for this more structured approach to dealing with the debt problems. It is consistent with HKAB's guidelines for handling corporate difficulties. It has to be recognized however that it may not be possible to save all the companies. Some of the worst performers will probably have to be liquidated and the banks will have to take the hit. But we should at least attempt to reduce the scale of the problem and to achieve an orderly transition to a new and more soundly based framework for China-related lending.

We are trying to keep closely in touch with market sentiment on this issue and to act as a channel of communication with the authorities on the Mainland. In this context, I would welcome any views that the Association would wish to give us. This returns me to the point that I made at the beginning of my speech. One of the important roles that the Association can play is to act as a focal point for industry opinion on the syndicated loan market. For this, and the other reasons I mentioned earlier, I very much welcome the establishment of the Association and I look forward to working with it to promote the development of the syndicated loan market in Hong Kong. ☺